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Playbook

RISK MITIGATION IN IT SOURCING

Jeremy Smith,
Managing Director

UK, Benelux &
Northern Europe

jeremy.smith@metrics.biz

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Small roadblocks on the way to success

IT sourcing can be a meaningful solution, but it is also always a risk. For years, there has been the perceived certainty that one third to one half of contracts do not bring the expected success. On the one hand, this is due to a shortfall in service performance, but on the other hand, it is also due to the expectations and general conditions which providers have to meet. Especially in times of volatility, uncertainty, complexity and ambiguity (VUCA), sourcing managers must prepare themselves as effectively as possible for each partnership.

To reduce the risk of a sourcing contract, it is important both sides proceed professionally: take enough time, prepare for the deal, bring realistic objectives, aim for meaningful goals. After all, the life cycle of a contract does not run on a straight road to the horizon, but often like a dirt road in rough terrain. Even a small mistake or a misunderstanding can throw the vehicle off track.

With this playbook we want to put you and your IT sourcing on the path to success. It includes some interesting slides we have recently published on this topic: They shed light on interesting facets which are often neglected in sourcing but can be decisive for success and failure.

> ***"In times of volatility, uncertainty, complexity and ambiguity (VUCA), sourcing managers must prepare themselves as effectively as possible for each partnership."***

For more than 20 years, Metrics has been supporting organisations in Europe with sourcing initiatives - on the side of the client as well as a neutral authority between the parties.

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Quantity and unit price: A difficult relation in IT outsourcing

As a rule, demand falls when prices rise and vice versa. This situation is usually different when it comes to the procurement of IT services. Our Data Lake shows interesting price trends for outsourced IT infrastructure services:

- When the purchase quantity is doubled, the unit price falls by around 15 percent. Example: initial quantity 100, new quantity 200; initial price per unit €100, new unit price €85.
- As volumes decrease, the contracts show a more pronounced price change: a 30 percent reduction in volume purchased results in a 15 percent price increase. Example: initial quantity 100, new quantity 70; initial price per unit €100, new unit price €115.

To prevent unpleasant surprises, organisations should limit the financial impact of volume changes during outsourcing negotiations.

Outsourcing service levels:
Go for differentiated penalties

In SLAs, specific values are assigned to the deviation levels S1 to Sx for falling short of agreed service levels (SL). This results in individual penalties for each service.

In our outsourcing consulting practice, we frequently find cases in which clients - often under time pressure - set wrong priorities, failed to consider different criticality of services, or did not align SLAs with business requirements.

In addition, it is important to formulate penalties or service credits with a sense of proportion: a penalty which does not hurt the provider is ineffective, while excessive penalties overshoot the mark.

Our sample matrix puts the impact of poor provider performance into multiple escalation stages. Deviation levels are assigned for each SL. For example, server availability: If performance misses the SLA by 0.1%, stage S1 applies; at 0.5%, stage S2 applies. The monthly charge for the service is reduced by the value determined in this way.

Deviation Level [S]	1st month	2nd month	3rd month	4th month	5th month	Later
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
S2	2.5%	5.0%	10.0%	20.0%	40.0%	60.0%
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]		
[illegible]	[illegible]	[illegible]				

Penalties

Sanction amounts are considered **contractual penalties**; damages in excess of these amounts may be claimed

The client may appoint a **task force** at the expense of the Contractor

Right to **mediation** or **extraordinary termination** either of individual services or as a whole

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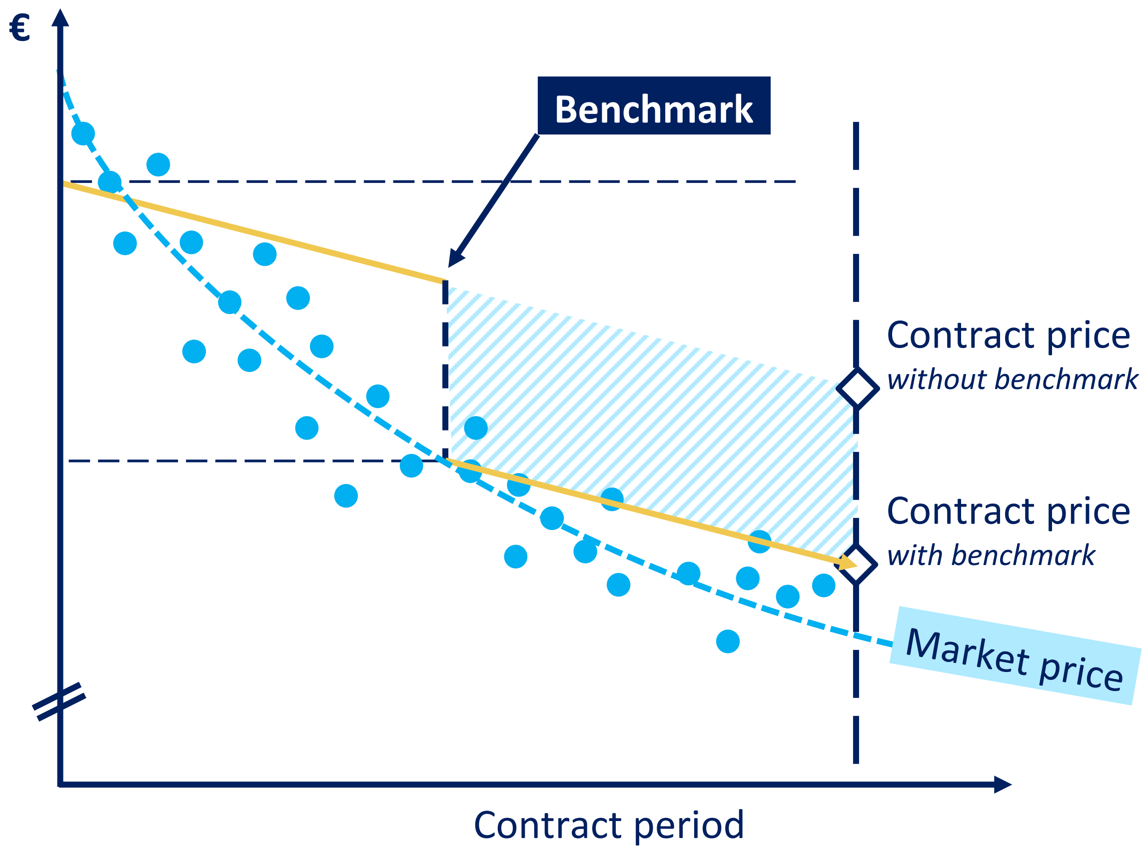
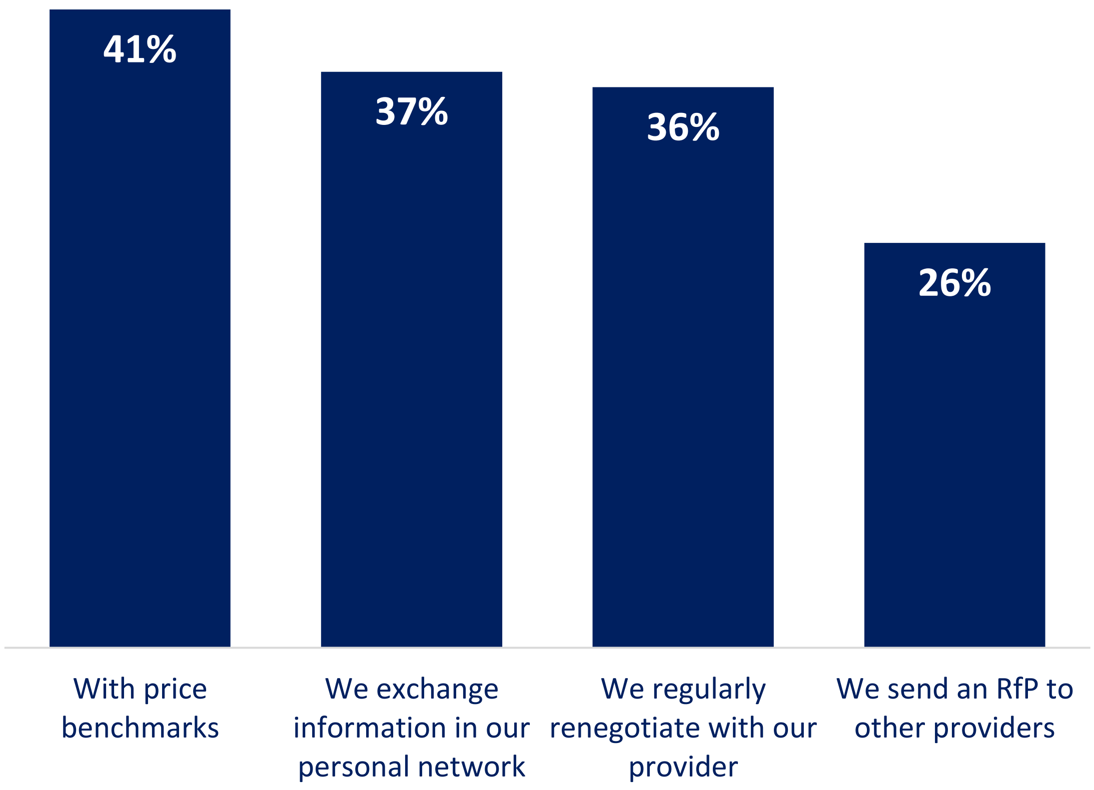
A powerful cost effect: Market price benchmarks



Market price benchmarks may have a strong impact on IT outsourcing prices – during negotiation, running contracts and at the renewal phase. In our chart, we show how a market price benchmark performs during the term of a contract.

An evaluation shows 45 per cent of outsourcing contracts include the implementation of a market price benchmark in the first twelve months, and another 40 percent in months 13 to 36. In two-thirds of the benchmarks, prices are lowered by an average of eleven per cent.

Best Practices for contracts: Optimising benchmark clauses



Source: IDG Business Media / Research Services; 2017 Sourcing Survey

Benchmark clauses in outsourcing contracts are an important instrument for regularly comparing prices with the market level by a neutral authority. Over the years, however, our advisory projects have shown benchmark clauses are becoming more and more detailed. Service providers and clients are increasingly insisting on their right to have a say, because after all, a lot of money is at stake. Thus, the parties involved give some thought to the benchmark in advance - but on the other hand, they do not define it precisely enough, for example in terms of reference values or dates.

This then leads to lengthy discussions which often strain the relationship between the contracting parties. Best practice: If both sides absolutely cannot agree on a point, they should at least agree a neutral authority will decide - either the benchmarker ….. or take a chance and draw lots.

More **information on benchmark clauses**

Not best practices in IT sourcing

01 Overly ambitious project plans

02 Not engaging all stakeholders

03 Unrealistic business case and expectations

04 Insufficient outsourcing readiness

05 Underestimating the complexity and effort of a tender

06 Too early or unclear information to affected staff and clients

07 Securing key personnel too late

08 Poor staffing and funding of the retained organisation

09 Unbalanced customer and supplier interests leading to an unsustainable relationship

10 Poor RFP causing poor decisions and additional efforts/risks in sourcing life cycle

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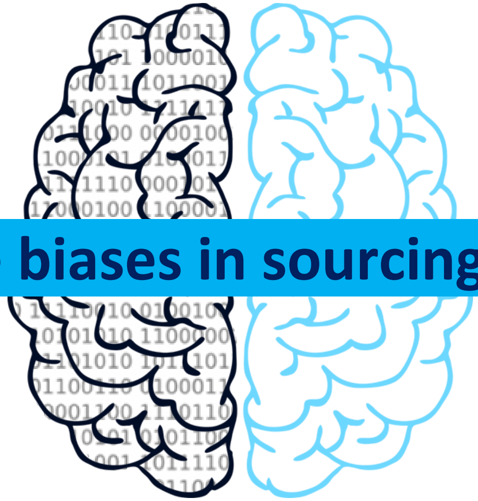
Negotiation pitfalls: Beware of the bias

- Dunning-Kruger effect
- Sunken-cost fallacy
- Loss aversion
- Status-quo effect
- Confirmation bias
- Anchoring effect



Cognitive biases in sourcing negotiations

People rarely make decisions purely according to objective criteria, because they are subject to certain "cognitive biases". These influences occur in situations which call for quick, intuitive decisions - such as purchasing situations or contract negotiations.

It's no wonder that companies are trying to take advantage of this effects: they put together special offers where people sometimes miss the mark. This has serious consequences, especially for complex decisions with long-term effects.

Those who know the consequences of their subjective perception can conduct difficult negotiations more successfully and achieve better results.

More **information on cognitive biases**

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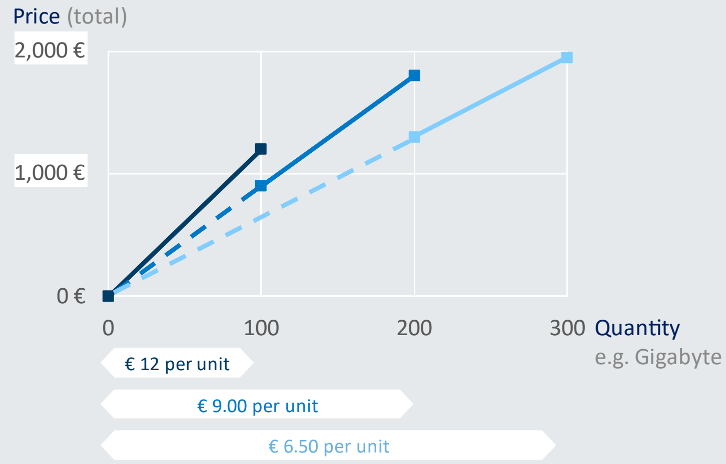
Tier Pricing:
A meaningful approach

One of the key success factors in outsourcing is an adequate pricing model. Especially in Managed Services, Tier Pricing is being used more and more frequently. What are the advantages?

Tier Pricing - also known as Tiered Pricing - refers to a quantity-based pricing model for IT outsourcing which is designed in layers or tiers over the years. This allows scale and learning effects (learning curve) to be worked into the pricing model, with low volumes having higher unit prices and higher volumes having lower unit prices.

More **information on tier pricing**

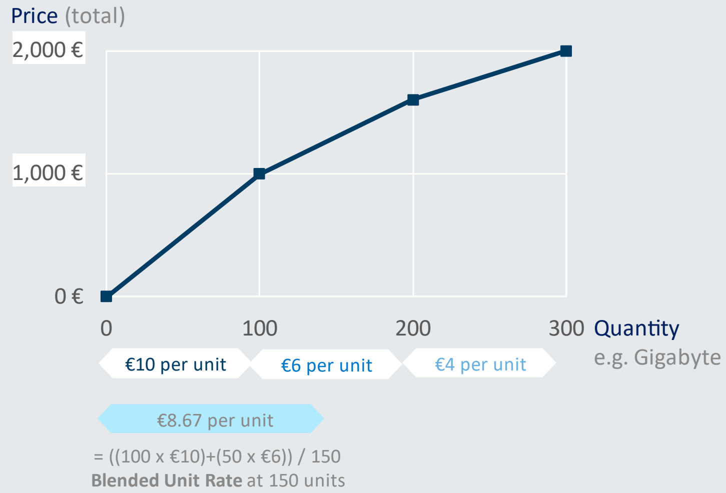
Total Volume Tier Pricing



If a defined threshold is exceeded, a new price applies to the entire quantity

- 0-100: €12 per unit
- 0-200: €9 per unit
- 0-300: €6.50 per unit

Incremental Volume Tier Pricing



If a threshold (upper limit) is exceeded, a new price applies to each unit above that threshold

- 0-100: €10 per unit
- 101-200: €6 per unit
- 201-300: €4 per unit

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Day rates: How to lower them

After the decline in 2020 due to Covid-19, the rebound in day rates for software development has been sustained, with new records now being set at all skill and experience levels.

Organisations can ensure, however, that costs and services of consultants are kept in a healthy balance. There are several ways to this - each one offers an individual savings potential, but also certain risks.

How to [optimise day rates 1]

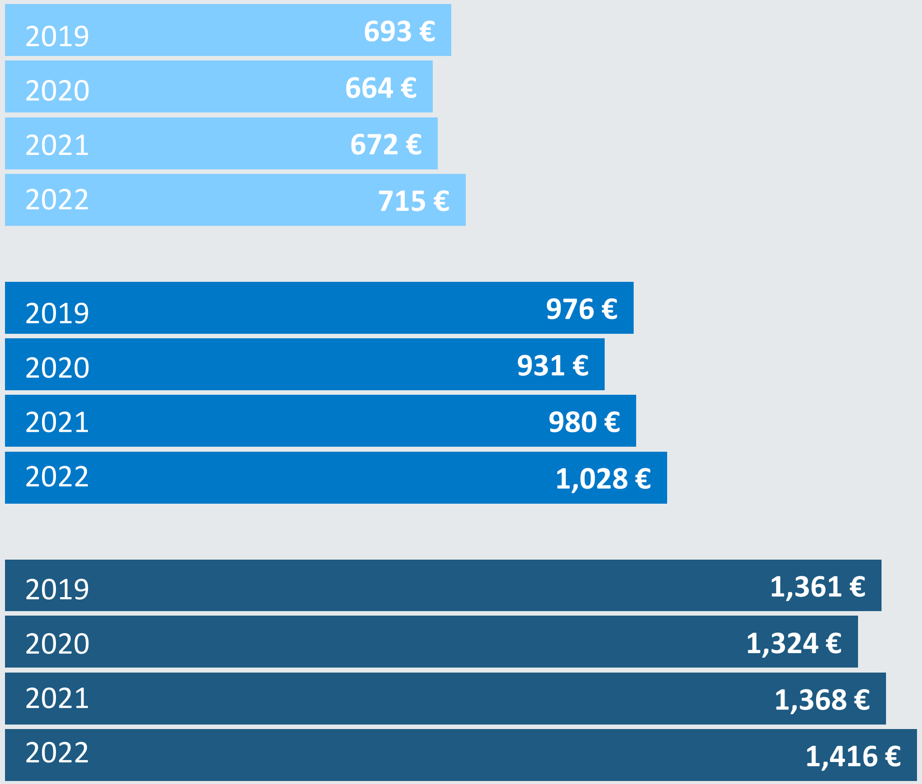
How to [optimise day rates 2]

Application Development Day Rates 2022

Developer: Design, implementation and maintenance applications > 3 years of experience

Senior developer: Design, implementation and maintenance of applications > 7 years of experience.

Special skills: Design and implementation of complete IT solutions; > 5 years of experience.



Rates for an eight-hour business day excluding VAT and travel expenses

Average values based on current price benchmarks by Metrics in Europe.

Day rates of freelance developers have not been included in the values.

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RFP vs. Benchmark: Knowing the options

When evaluating their IT services, for example in the context of a contract extension, organisations have the choice between a market price benchmark and a request for proposal (RFP). The options cannot be exchanged at will, and each fulfils a certain purpose.

Dissatisfaction with the current service provider

New or significantly changed requirements

Focus on selecting an ideally suited service provider

Satisfaction with the current service provider

Requirements are largely constant

Focus on testing the price-performance ratio in relation to the market level

A comparison of an RFP and market price benchmark is worthwhile - especially if a current contractual relationship is to be extended with updated prices and services. Experience shows an RFP takes longer and requires more resource than a market price benchmark. Companies using an RFP must expect a factor of two to three. Additionally, a benchmark gives quick evidence for a confident decision, is able to match services with requirements and provides current market rates for each service.

Wishful thinking is not an RFP strategy

1	"We know all relevant IT providers for the tender"	Take a 360⁰ perspective on the market and sensible suppliers
2	"We expect your offer by 31 December EOB"	Allow the providers the necessary time and dose the pressure sensibly
3	"All IT services must fit to our individual business requirements"	Make consistent use of standardisation potential to optimise costs
4	"We will define the shortlist on the basis of the bids received"	Qualified shortlisting should always be based on objective and comprehensive criteria
5	"The contract will be signed and sealed in the next quarter"	Do not put yourself under pressure and assess the general conditions realistically

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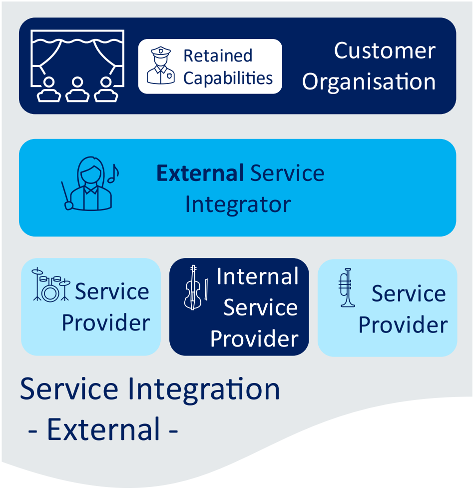
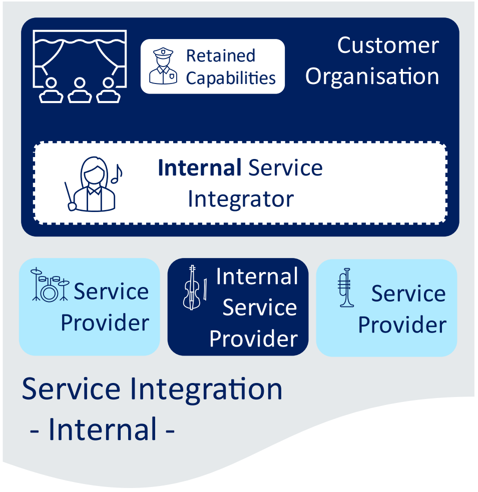
Vendor strategy: Beware of integration

To reduce the risk, one service provider is no longer used for everything. In a multi sourcing model, the requirements of service integration are added to the activities of provider management. Service integration can be provided internally, externally, hybrid or by a lead supplier - with varying degrees of success in practice. SIAM for multi sourcing has become popular in this context.

Multi sourcing, however, also means "multi-interfaces". Without an adequate approach, these lead to service problems and increased escalations with responsibilities which are often unclear between service providers and customer organisations.





*Source: Metrics Survey 2020 IT Sourcing

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IT sourcing in really disruptive times

How should CIOs develop a future-oriented sourcing strategy?

As always, the IT strategy should be derived from the business strategy, and this also applies to KPIs for managing IT. Then comes the sourcing strategy, where flexibility is currently of primary importance. Managed services form a good foundation, but flexibility in capacity through elasticity and scalability is crucial if you want to react quickly to changes in business and IT strategy ….. and we have seen in the past two years how quickly a stable situation can change.

Why should business units be involved in IT sourcing?

Business units already account for a significant part of IT expenditure. Therefore, IT organisations should not sit on the sidelines, but quickly close existing gaps in the relationship. Otherwise, IT and sourcing strategies will diverge. This is reflected in the trend of 'citizen developers' with an increasing use of low-code and no-code tools.

"Organisations need a multi-layered sourcing concept with extensive vendor management alignment to orchestrate services and providers - ideally technology-agnostic."

Dr Jakob Rehaeuser, Practice Lead IT Sourcing at Metrics

IT sourcing in really disruptive times

What impact do you expect on IT sourcing consulting?

I am pretty sure increasing complexity in sourcing will continue to drive demand for consultants. After all, you don't just pull a sustainable multi-provider strategy for managed services, cloud and staffing services out of your hat. Organisations need a multi-layered sourcing concept with extensive vendor management alignment to orchestrate services and providers - ideally technology-agnostic. One facet, for example, is the management of contracts and reporting, including renegotiations and escalations. And of course, business units also need IT sourcing competence, especially in an economically challenging environment.

"Rising Cloud costs? Think of the end at the beginning."

In which situations can benchmarking help in IT sourcing?

While cost benchmarks target internal IT, market price benchmarks are applied in all phases of the sourcing lifecycle. This starts with make-or-buy analyses and simulations, extends to the comparison of offers, service levels as well as current market prices in negotiations and includes renegotiations at the end of a contract term. It is about using one's own key figures and comparing them with values from other organisations to determine one's location and meaningful goals in a non-transparent market.

How should one tackle the planning and allocating of cloud costs?

Cloud computing is a double-edged sword: It makes IT faster, but quick decisions can also backfire. The speed and flexibility of the Cloud have come at a price, and this was not really communicated at the beginning: the promise of cost reductions was willingly believed. And because the Cloud was often a strategic decision, some business cases were also not hard-calculated or followed up. Therefore, the old motto from the golden outsourcing era still applies in the Cloud: 'Think of the end at the beginning'.

METRICS GROUP

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Data Driven Decisions

UK, Benelux and Northern Europe

Metrics Maturity UK Ltd.

New London House

6 London Street

London EC3R 7LP

Phone: +44 20 3832 2937

www.metrics.biz

Jeremy Smith

Managing Director

+44 7802 175 436

jeremy.smith@metrics.biz