Chapter 6.2
Managing Risks of IT Outsourcing

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ABSTRACT

Outsourcing is one of the most talked about and widely debated topics. Over the past few years, firms have been outsourcing their IT operations at increasing rates. The fact that firms are turning to outside vendors in increasing numbers in order to meet their needs does not mean that outsourcing is without problems. Firms often enter outsourcing deals without considering risks or assuming that all risks lay with the external service provider. In this chapter, we provide an overview of IT outsourcing, its risks, and a model for managing those risks. We identify different firm-vendor configurations for sustaining long-term relationships aimed at diversifying risk over time and discuss the need for psychological contracts to manage such outsourcing relationships.

INTRODUCTION

Outsourcing is one of the most talked about and widely debated topics. Firms are outsourcing their IT operations at an increasing rate over the past years. Research by Gartner projects the worldwide IT outsourcing market to grow from $180.5 billion in revenue in 2003 to $253.1 billion in 2008 at a compound annual growth rate (CAGR) of 7.2% (Caldwell, Young, Goodness, & Souza, 2004). Some of the top reasons for outsourcing are cost reductions, the ability to focus on core competencies, access to specialized expertise, relief from resource constraints, and to eliminate problem areas.

The fact that firms in increasing numbers are turning to outside vendors in order to meet their needs does not mean that outsourcing is without problems. While outsourcing has helped organizations achieve major benefits such as cost savings, increased flexibility, higher quality services, and access to new technology, unsuccessful outsourcing experiences have also been reported in which suppliers have failed to meet expected service levels and deliver expected cost savings. IT outsourcing has thus become one of the most talked about and widely debated topics. Please see Figure 1.

In spite of outsourcing failures, IT outsourcing continues to grow and outsourcing options continue to expand. As the MPEA case study, above shows, it has become more important than ever to understand the risks associated with these different options. Enterprises often enter outsourcing deals without considering risks, assuming that all risks lay with the external service provider. A large number of studies show that the risks associated with various options need to be managed on IT outsourcing. In this chapter, we provide an overview of outsourcing risks, and a model for managing them. We identify different firm-vendor configurations for sustaining a long term relationship aimed at diversifying risk overtime and discuss the need for psychological contracts to manage outsourcing relationships.

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IS outsourcing has been defined in many different ways by different researchers. Williamson (1985) defines it as a market vs. hierarchy decision, Rands (1992) defines it as a make or buy decision, while Gurbaxani and Whang (1991) and Porter (1980) define it as "vertical integration." In this chapter, IT outsourcing is broadly defined as a decision taken by an organization to contract-out or sell the organization's IT assets, people and/or activities to a third party supplier, who in exchange provides and manages assets and services for monetary returns over an agreed time period (Loh & Venkatraman, 1992). The definition is very broad and includes all types of outsourcing. The IT resources can either be transferred in part or

Figure 1. Metro-Pier case study

Case Study: Metropolitan Pier and Exposition Authority

Metropolitan Pier and Exposition Authority (MPEA) owns and manages the McCormick Convention center, a business gathering facility, and the Navy Pier, a popular tourist attraction. In early 1998, MPEA with limited capabilities did not consider itself to be a technical service provider. However, on occasions clients requested local area network and Internet services for their conventions. At that time, MPEA opted to outsource the Internet and network services to a third party. In January 1998, MPEA signed a three year revenue-sharing deal with RedSky Technologies for all the show-floor network services.

Soon thereafter, MPEA's business requirements started changing. Increasingly customers were now requesting IT services - private virtual local area networks, firewall implementations, and high-speed bandwidth, MPEA sensed that offering such value-added services would add to their core competencies.

RedSky chose not to expand to meet the demands of MPEA. They would only design and build a new network for each convention, leaving MPEA to tear it down after the show. At this point, MPEA decided to insource the IT services and did not renew the three year contract. MPEA spent $1.5 million initially to build the infrastructure and since then they have been successfully delivering all Internet and network services requested by their convention clients.

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