Chapter 2.24
Is the Business Model Broken?
A Model of the Difference Between Pay-Now and Pay-Later Contracts in IT Outsourcing

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ABSTRACT

This chapter seeks to evaluate the dominant IT outsourcing contracts model (pay-later) as compared to an alternative model (pay-now) in light of changing economic conditions. We integrate practitioner observations in the spirit of mathematical transaction cost problems to develop a conceptual economic model to compare these two types of contracts. We uncover three very important facts which suggest that pay-now contracts are always at least as good as pay-later contracts, and pay-now contracts are better than pay-later contracts when economy is volatile. These findings provide a rich insight into the problem of failing IT outsourcing contracts since the prevailing poor state of economy. We further discuss the implications of our findings and suggest that simply shifting the contract from a pay-later to a pay-now will fix the IT outsourcing business model.

INTRODUCTION

In a recent Fortune magazine article, one of the interviewees, William Nygen of Oakmark funds, comments on outsourcer EDS's business model. He brings up the possibility that "the business model is worse than we thought it was" (Loomis, 2003, p. 74). This chapter is an investigation of the business model not just of EDS, but of information technology (IT) outsourcers across the board.

For a decade or more outsourcing has been hailed as the panacea for IT problems (Lacity

& Hirschheim, 1993). Some industry observers go so far as to claim that outsourcing is *the* payoff from IT (Kirkpatrick, 2002). However, the analysis provided in this work shows that there are fundamental problems with the traditional IT outsourcing arrangement. In short, the business model is broken. Fortuitously, the analysis also suggests an easy way to fix the problem.

This work shows that the back-end loading of IT contracts results in misalignment between clients and vendors. This misalignment results in transactions, which should take place, failing to transpire, resulting in losses to both client and vendor. The findings presented here help explain why more than half of IT outsourcing contracts must be renegotiated (Caldwell, 1997; Lacity & Willcocks, 2001). The model also suggests that simply moving from a back loaded to a front loaded contract will fix the business model.

The rest of the chapter is organized as follows. In the next section we briefly review the relevant literature on IT outsourcing. Following that, we present two models of how to structure an IT outsourcing contract and show how they result in different levels of value. We then derive three propositions for IT outsourcing based on these two models. Finally, we conclude with a discussion of the implications of this work and directions for future research.

LITERATURE REVIEW

Our background literature is a combination of practitioner observations and economic modeling. From the practitioner side we find three stylized facts. First, IT outsourcing contracts are typically back-loaded, with the vendor offering discounts early in the contract and receiving profits in the later periods of the contract. Second, a majority of IT outsourcing contracts have to be renegotiated before conclusion. Lastly, the cost for the baseline services is very close to the vendor's cost, but additional services command considerable margins.

IT outsourcing contracts, and here we are speaking of the *total* outsourcing deals, usually begin with the vendor purchasing the assets of the client and hiring all of the client's employees. Frequently, the vendor will overpay for the assets and in some cases offer loans to the client (Lacity, Willcocks, & Feeny, 1995). In fact, in a study of the top reasons for outsourcing, The Outsourcing Institute (1998) found that number ten was the *cash infusion* offered from vendor to client. However, like any pay-later deal, the bill eventually comes due and the vendor recaps the initial capital outlay by charging more in later periods.

Interestingly, practitioner research indicates that more than half — 53% to be exact — of outsourcing contracts are renegotiated before running their full term (James, 2000). For example, less than two years after signing an IT outsourcing agreement with Computer Sciences Corp., health maintenance organization Oxford Health Plans Inc. canceled the deal (Rosencrance, 2002). Halifax bank of Scotland abruptly ended a 10-year contract with IBM after only two years (Arminas, 2002). Mony Insurance of New York canceled a $210 million contract with Computer Sciences Corp. less than half way through it (Caldwell, 1997). Chase Manhattan Bank paid $15 million to terminate its contract with Fiserv, and Zale Corporation terminated a 10-year contract with ISSC after only 5 years (Lacity & Willcocks, 2001).

Why must so many contracts be renegotiated? One standard complaint is that the contract performs well for some time and then the costs of add-ons and additional services begin to overwhelm the client (Barthelemy, 2001). Even academic research shows that lack of flexibility, as defined by the cost of reacting to changes, is the prime source of contract failure in IT outsourcing (Lacity et al., 1995).

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