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The Winner’s Curse in IT Outsourcing:
Strategies For Avoiding Relational Trauma

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The Winner’s Curse in IT Outsourcing: Strategies For Avoiding Relational Trauma

ABSTRACT

IT outsourcing’s adoption by some of the largest international corporations has seen outsourcing become a key component of the Information Management agenda. However, the process of evaluating, selecting, and subsequently contracting out or selling the organization’s IT assets, people and/or activities to a third party supplier raises significant concern in light of the inherent ‘Winner’s Curse’ that may arise when the supplier over-promises on what can be delivered for the contract price. This paper presents a longitudinal outsourcing case study that explicates the often abstruse Winner’s Curse, its effect on post-contract management and the relationship, and how it was alleviated by agreeing to mutually renegotiate the terms of the deal. Building on auction and IT outsourcing theory, the paper provides both a model of IT outsourcing processes, and a Winner’s Curse typology for understanding IT outsourcing ventures. The study finds that a Winner’s Curse in outsourcing may not be evident to either party during negotiations. However, it will result in additional costs for both parties in the form of increased management time and resources; may result in service slippage and high dissatisfaction levels and possibly demand service level renegotiations; may lead to relational loggerheads; and ultimately may result in early contract termination. To avoid experiencing such a relational trauma as a consequence of a Winner’s Curse, this paper identifies six lessons that client and supplier companies should consider before signing IT outsourcing deals. The key message being ‘never mistake a relationship for just an auction’ – outsourcing is a long-term venture.

Keywords:
IT Management, IT Outsourcing Relationships, Auction Theory, Winner’s Curse
The Winner’s Curse in IT Outsourcing: Strategies For Avoiding Relational Trauma

1. Introduction

Information technology (IT) outsourcing is the practice of contracting out or selling the organization’s IT assets, people and/or activities to a third party supplier for monetary payments over an agreed time period\(^1\). IT outsourcing continues to experience a phenomenal adoption rate in North America, Europe and more recently Australia. Having reached an estimated market size of approximately $140bn in 2001\(^2\), it has evolved into a viable, yet at times risky, management option to handle today’s extensive information management agenda. At the same time IT services has evolved into a highly competitive marketplace, with consequences for how suppliers bid and secure contracts, particularly in times of market downturn, for example during 2001\(^3\).

Indeed, selecting the right IT supplier, on the right terms, poses an ongoing challenge. The difficulty here frequently lies in choosing the evaluation criteria that satisfy the client organization’s objectives for outsourcing in the first place - commonly those benefits that the internal IT organization is not able to deliver, but that the supplier(s) can offer. The major criteria have been identified as financial, business, technical, strategic and/or political benefits\(^4\). The most common benefits sought are financial, typically cost savings of between 10 to 40%, improving cost control and clarity, and increasing cash flow. Business, strategic and/or political benefits have involved new business start-ups, process re-engineering, a refocus on the client’s core competencies, assisting in managing mergers or globalization, and diminishing the often political debates about new IT projects\(^5\). Finally, the technical benefits commonly on offer have included access to expertise, improved services, new technologies and technological innovation\(^6\). The general lure of ridding oneself selectively or totally of the ‘IT investment pit’, and instead paying a fixed monthly sum for IT services or on a ‘pay-for-use’ basis, remains a major measure for selecting a supplier. However, we do not fail to recognise that organizations typically outsource for a selected mix of the above reasons.

However, in a highly competitive marketplace, a client’s focus on cost savings can drive supplier organizations into the corner of making service delivery promises that are initially calculated on a slim or even nil profit margin. They may do so, for example, because they are short of business due to recession, have become less powerful competitively, or are a new entrant into the IT services market. Relatedly, suppliers may be keen to enter a new market segment, want to lock out competitors, have a strategic intent to dominate certain market segments, and/or they believe that they can recoup the investment and broaden margins later. Parallel research studies frequently uncover such strategies, as we shall see later. It is precisely in such circumstances that the danger of a ‘Winner’s Curse’ arises, as suppliers make unrealistic bidding promises to ensure they win the contract, but already know, or subsequently discover, that they are unable to recover their tendering, business and operational costs for the near future\(^7\). The inherent danger being that client management might treat the bidding event as a one-off purchase process for services, while the process’s impact on the subsequent venture is far more long-term in nature.
Instead suppliers take a risk in hoping that they can recover their costs by, for example, identifying service areas that are in need of urgent attention and/or areas of immediate service provision that are excluded from the contract but needed operationally – so meriting excess fees. In addition, suppliers will attempt to offer additional services from their portfolio of technology capabilities, service management and consultancy services over the life of the contract. Since supplier account management will need to concentrate disproportionately on recovering costs, and may well be under pressure from its senior managers to make stipulated margins in unfavourable circumstances, it is more than likely that trade-offs will occur that disadvantage the client. For example, case studies demonstrate that where a supplier seeks to decrease its costs, this can result in decreases in service quality and additional costs for the client. A supplier’s disproportionate concern for containment of its costs can lead to inflexibility in the interpretation of the letter and spirit of the contract, which can also lead to adversarial relationships. Thus operational performance and the client–supplier relationship will receive less attention and suffer. As a consequence, we suggest that in ‘Winner Curse’ situations suppliers will likely jeopardize the success and effectiveness of the operations and outsourcing relationship as their focus settles primarily on recovering their costs, and not on developing and maintaining the relationship and mutual objectives. A supplier would thus likely undertake opportunistic behaviour, seeking to reduce its own operational costs, often at the expense of the client, as Williamson (1975) suggests.

This paper presents an IT outsourcing case history illustrating the relational trauma a client and its supplier experienced as a direct consequence of what auctioning has coined the Winner’s Curse. A curse was found to occur when the winner of a tendering event systematically bids above the actual value of the business and thereby systematically incurs losses for the benefit of winning the deal. In IT outsourcing such an event occurs when a supplier deliberately or unconsciously over-promises on the contract bid, and the bid is subsequently accepted. In a field still relatively under-theorised, studying IT outsourcing from this perspective makes a distinctive contribution to our understanding of outsourcing supplier practice, not least because IT outsourcing bid teams are often separate from those who have to deliver the service once the bid has been won, and may well be rewarded on different criteria. For practitioners the paper, in turn, highlights the practice and suggests preventive strategies, but also emphasizes that in all IT outsourcing deals, client organizations need to have a carefully selected management team that actively develops, maintains and manages the deal, to be able to avoid, or belatedly recognize and deal with, the damaging outcomes inherent in the Winner’s Curse.

2. Selecting The Supplier

Selecting a supplier is a costly undertaking in terms of time, effort and resources. But the investment in identifying the right supplier and contract bid is paramount to the success of the overall outsourcing venture. Hence the criteria that generally informs the selection process is a richly researched area in outsourcing. Yet we actually know very little about the consequences of a wrong selection, and its impact on subsequent post-contract management, the outsourcing relationship, and financial and organizational outcomes. It is here that this research and paper makes a major contribution.
Typically, the general outsourcing selection process begins in earnest with the short-listing of relevant suppliers. An open short-list process, in which clients advertise for suppliers to apply, and a closed short-list process, in which suppliers are directly approached by clients are common approaches here\(^\text{13}\). Once shortlisted, suppliers will be issued a request for information (RFI)\(^\text{14}\). An RFI commonly outlines the customer’s objectives, services, assets, transfers, and issues of relevance to its outsourcing intention. Suppliers will respond with their approach to addressing a customer’s outsourcing ambition, its capabilities, track record, reference sites, and associated information\(^\text{15}\). Those selected are then invited to tender (ITT) and issued a request for proposal (RFP). Depending on the company’s approach, the tender or proposal is commonly the means by which detailed dialogues and information exchanges are initiated to further narrow down a select group of suppliers, who then define a bidding contest for the outsourcing deal\(^\text{16}\).

The final selection is then expected to be preceded by a phase of careful evaluation of the various supplier bids. Practice shows, though, that customers will often choose suppliers on a subjective basis informed by qualitative issues, especially where the quantitative assessment is more or less the same for all bids. Additionally, poor in-house evaluations of costs and services by customers may also mean that over-promising by suppliers will be initially accepted as a superior bid. In either circumstance a ‘Winner’s Curse’ scenario becomes more probable.

2.1. Confronted by a Winner’s Curse

An intriguing phenomenon in auctioning and bidding scenarios is the Winner’s Curse. The Winner’s Curse occurs if the winner of an auction or bidding event systematically bids above the actual value of the objects or service and thereby systematically incurs losses. Acceptance of a bid in general is an informative event, and the failure to incorporate such contingent information into the bidding strategy can lead to excessive bids and subsequent losses for both parties. Each bidder must recognize that she wins the object only when she has the highest signal. Failure to take into account the bad news about others’ signals that comes with any victory can lead to the winner paying more, on average, than the prize is worth, something found to happen quite often in practice\(^\text{17}\). The winner’s curse occurs in normal auctions, in which the auctioneer is the seller or represents the seller and the bidders are the buyers who have values for the object(s) sold. The auctioneer is usually seeking a high price for the object. The winner’s curse also occurs in procurement auctions (also called tendering), where the auctioneer is the buyer and the bidders are sellers who incur costs in supplying the object(s) bought\(^\text{18}\). In that case the auctioneer is seeking a low price. In this article we focus on the latter - that is, the winner’s curse in a procurement auction of IT outsourcing contracts and its impact on and consequences for the relationship between the customer and the winning bidder.

Persistent overbidding in tendering situations has been observed in laboratory experiments. Kagel and Levin\(^\text{19}\) for example report that losses due to overbidding are more common in auctions with large number of bidders, than in small numbers, but losses are likely to occur in both scenarios. Losses, however, can be minimized with awareness and experience of such tendering and auction events. Lind and Plott\(^\text{20}\) illustrated, though, that the Winner’s Curse is a general phenomenon exhibited by most bidders and in most bids. It all comes down to what Capen et al.\(^\text{21}\) noted that: ‘bidders want to win’. As we shall see, this applies in IT outsourcing as anywhere else.

Auctions have not only been a perennial feature of doing business in many sectors, but the phenomenon has been increasing with the recent development, for example, of B2B exchanges
and on-line auctions. Interestingly, the theory of auctions would suggest that the Winner’s Curse is asymmetric. The person who wins suffers the curse alone. In the normal auctions for physical products like cars, houses, agricultural products etc. this is usually the case. However, especially in procurement auctions for contracts and rights in business settings, this is not the only likely outcome. For example, a supplier winning a ‘cursed’ deal on a B2B exchange may well cut his losses by providing lower quality products or service to the customer. A buyer winning what turns out to be a cursed deal may well drive a much harder deal in terms of service guarantee rather than price next time with the same supplier, or remove that supplier from the favoured supplier list altogether. In all sorts of markets a Winner’s Curse can have consequences for several parties, over months or even years. In such circumstances auctions themselves may well be better conceived as relationship building exercises rather than one-off bids. Therefore, in these situations the auctioneer could assist the bidders in greater clarity on the auction process and the objects auctioned and its value. The auctioneer could also take steps to reduce the potential problem prior to the auction or to help the winner after the auction. One illustrative example in an IT outsourcing context occurred in the EDS-Inland Revenue deal cited by Willcocks and Kern (1998) They quote an IR respondent saying: ‘If you are minimising bid costs, and not driving incentives down for the supplier, you are doing something really rather helpful to the potential deal down stream…. Acting otherwise you can damage the relationship irrevocably’.

3. The Reality Of A Winner’s Curse in IT Outsourcing

The outsourcing selection and bidding process has strong similarities to such auction situations. In IT outsourcing, various suppliers may be asked to bid to provide IT services, even though all too frequently the exact value and service requirements cannot be clearly determined. In BP Exploration’s undertaking in 1992, six suppliers were eventually asked to bid for the offered services in circumstances where the exact future service requirements were not certain. Decisive criteria for winning such bids tends to be costs, value added benefits, technology, expertise, capabilities and reputation or prestige of bidders. The difficulty in such bidding circumstances is to select those suppliers that offer the best deal, and here the focus tends to be not least on what cost efficiencies suppliers can deliver. The assumption here is that suppliers have sufficient economies of scale, and superior IT management practices, to be able to deliver improved services for a cheaper price, and that the resulting savings are those that the client will benefit from.

A danger that has become more apparent over the years to researchers studying IT outsourcing experiences, is the often large disparity between what suppliers initially tout in their proposals and what at the end of the day is delivered. In fact, some companies and government institutions have found outsourcing services to provide few measurable improvements or additional benefits; and in the late 1990s some have even subsequently terminated contracts early (for example American Express, East Midlands Electricity, Sears UK). These and similar cases seem to suggest that suppliers can be overly keen to win a particular deal for possible reasons of prestige, size, partnering, costs, and long-term business opportunities. To reiterate, the resulting bid suppliers may make in such situations are calculated at cost leaving a very small margin upon which they could make a profit. Indeed, suppliers may even sign a deal, or part of a deal almost as a ‘loss leader’, assuming that additional business will arise upon which they can make money. Thus, for example, in its 1993 ten year deal with the UK Inland Revenue, EDS made
losses for several years running the IR’s data centers. Profitability only emerged in the late 1990s from the economies of scale achieved by consolidating the IR data centers with those of the Department of Social Security – a deal also run by EDS.\textsuperscript{28}

Additionally, suppliers often have to bid on the basis of incomplete information, as the overall IT environment of an organization is often too highly integrated to evaluate objectively the actual service costs and technical requirements. IT is also a difficult area to bid for accurately, and differs from other types of outsourcing in several respects. Firstly, IT is not homogeneous but comprises a wide variety of activities, skills and technologies whose differential costs and impacts cannot easily be assessed or accounted for. This is particularly true in IT development projects, which have so many intangibles, for example turning tacit internal firm routines into workable code that mirrors those routines, and employing new, unstable technologies and getting them to work in specific business contexts where requirements keep changing. Secondly, IT technical capability continue to evolve at a dizzying pace, making it difficult to predict IT needs with any certainty. Thirdly, and relatedly, there is no simple basis for gauging the economics of IT activity – there are few industries where the underlying economics shift as fast as in IT. Fourthly, IT value often lies in the cross-functional integration of business processes, and the penetration of IT into the core of organizational functioning. Such value is difficult to measure and contract for. Fifthly, and for some of these reasons, in-house IT evaluation has an indifferent track record. This frequently makes like-for-like comparisons of in-house against supplier bids difficult to achieve. As one example, in one 1999 deal we researched, supplier bids were benchmarked against an estimate of in-house costs that was subsequently found to be 70 per cent understated. All these factors came together in one telecoms outsourcing deal we studied in 2001. On the supplier’s calculations it was scheduled to cover its costs in the first year and move to operational profit thereafter. The supplier actually made a $US 15 million loss in the first year, a result likely to impact on the client as well as the supplier over the next four years of the contract.

The likely danger all this implies is that suppliers can out-bid themselves and subsequently find it impossible to continue with the deal as priced and structured. This is, of course, only one of many possible scenarios. Figure 1 illustrates the main possibilities relevant to this paper, and will be briefly explained. Logically, the supplier bids for an IT outsourcing contract against other suppliers. In Figure 1 the supplier experiences a ‘Winner’s Curse’ when it wins the bid but at too high a cost. As we shall see, this can subsequently have either negative (Lose-Lose quadrant of Figure 1) or positive impacts on the client company. On the other hand, the supplier may win a bid that secures its required profit margin while delivering on the client’s costs and service expectations (Win-Win quadrant of Figure 1). But it may also be that the supplier secures its profit margins, but at too high a price for the client. As we will show in a later analysis of over 80 deals, all four outcomes regularly occur in IT outsourcing, with a degree of subsequent dynamism and shift, depending on supplier and client managerial responses to the circumstances they find themselves in.

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\textbf{Figure 1 – The Winner’s Curse And Other Scenarios In IT Outsourcing}
We posit that, due to the supplier’s mis-calculations, the operationalisation of the contract and the outsourcing relationship are likely to suffer severely in a Winner’s Curse situation as we have defined it, with the supplier under pressure to make its costs, and possibly a margin. If the client controls the situation tightly the Winner’s Curse may well only affect the supplier. However, the effect may well also be diminished services, lower number of supplier staff and less experienced staff actually in charge of the deal. The client itself may well be faced with the consequences of a Winner’s Curse, resulting in significant additional costs, and the need for increased management input to alleviate the frustrations of users and staff (Figure 1). Other costs may, for example, also result from not getting the much needed new IT system and therefore remain at a competitive disadvantage. In such circumstances, the question arises whether outsourcing remains viable for the client, or whether a significant return to in-house sourcing defines a better option. In practice, what makes IT outsourcing distinctive is the high switching costs of ‘back-sourcing’. In one deal we examined, a 10 year $US550 million deal was terminated after only 17 months. Additional implementation and termination costs to the client were estimated at $160 million. Not surprisingly, with such prohibitive switching costs, many clients may make the judgement that continuation of a ‘cursed’ outsourcing arrangement may be the lesser of two evils.

Of course, evidence of such circumstances is rarely publicised and explicit. But it does exist. For example a recent academic research study\(^\text{29}\) found 21 of the 85 outsourcing deals studied as in failure mode, but only eight had the contract terminated prematurely. On one argument, the likelihood of such circumstances will increase over time as the growing competitive pressure on suppliers due to the ever augmenting IT outsourcing market will push them to compete increasingly on prices and service deliverables. This paper provides a first hand account of a Winner’s Curse scenario, showing how an IT outsourcing arrangement developed into a Winner’s Curse first for the supplier and then also ‘cursed’ the client company, how other scenarios could have developed as illustrated in Figure 1, but how, and by what means, the relationship was converted eventually into a ‘No Curse’ arrangement for both parties.

5. Relational Trauma at CLIENTCO Oil\(^2\)

CLIENTCO is an affiliate of one of the largest petroleum companies in the world. It is an ‘integrated’ oil company combining the ‘upstream’ activities of oil exploration and production with the ‘downstream’ activities of refining, research, distribution and sales. Plagued by ongoing cost and operational efficiency pressures, petroleum firms such as CLIENTCO have been driven to focus on their core operations and source other services from the market.

In 1994 CLIENTCO consequently signed a five year, $US 8 million, selective IT outsourcing deal with Supplier A for legacy application support services. CLIENTCO only ever contracts suppliers for selective services as, historically, no single supplier had been found to deliver all their requirements to required standard. Secondly, careful selection of small niche suppliers ensured that CLIENTCO’s business would be of strategic significance to the supplier, assuring greater attention and control. Thirdly, they chose suppliers who closely matched their culture – a key factor in their outsourcing strategy.

\(^2\) To guarantee the company’s and participants request for anonymity all names had to be changed.
Supplier A’s Selection
SUPPLIER A was specifically asked to present a competitive bid against another supplier (B), who at the time was contracted to deliver application support services. SUPPLIER B at the time was the preferred supplier, having supplied CLIENTCO with IT services for the previous seven years, but they were also perceived as expensive. Consequently, SUPPLIER A was implicitly asked to make a lower price offer, undercutting SUPPLIER B to such an extent that it became worthwhile for CLIENTCO to switch:

“they [SUPPLIER B] did it on a day-rate basis and they were the company that moved us the furthest forward in terms of proactively showing us how to do applications support and development better. But, at a cost. This was a Rolls-Royce service” (Senior Manager, CLIENTCO).

SUPPLIER A’s strong price offer, fuelled by its keenness to acquire business from a ‘Blue Chip’ company like CLIENTCO, gave SUPPLIER A the impetus to outdo SUPPLIER B. However, the low margin calculation SUPPLIER A made was to cause much strain in the initial years and consequently raised questions in CLIENTCO over whether cost-saving offers procured through a competitive benchmarking or tender process should not be scrutinised more closely before actually contracting with the competing bidder.

The Specifics Of The Deal - The Contract
In 1994 CLIENTCO signed a five year, fixed cost contract with SUPPLIER A for the provision of legacy application support services. The contract was structured into two parts: on the one hand, a core service had to be supplied continuously according to service level agreements; on the other, an enhancement service was required that varied according to CLIENTCO’s changing requirements. Pricing of the service provisions was also split into two parts. Core services were priced on a fixed monthly call fee of $73,000 for all legacy application and system services. All add-on change requests varied according to agreed and accepted prices. However, on average CLIENTCO spent an additional $67,000 a month on service additions and changes. Overall CLIENTCO was paying approximately $US 140,000 a month in total.

The contract was structured to assure CLIENTCO an annual cost reduction in the flat rate charges for the core services: “it’s reduced by $30,000 the first year, and a further $15,000 in each following year” (Customer Service Manager, SUPPLIER A). The effect of shrinking the amount of work implied that the service provisions would become at some point redundant. The planned time for this was 2004, at which point most applications would be operational on a client/server infrastructure. In turn, SUPPLIER A’s revenues would tail off over the next seven years. Naturally, this put additional pressure on SUPPLIER A’s managers to identify new areas of business.

Taking Over the IT Services - Transition Period
The transition period for SUPPLIER A started in earnest mid-1994, with the takeover of existing service arrangements from SUPPLIER B, and the application of their expertise to provide the promised cost reductions. According to CLIENTCO, operationalisation of the deal was a straightforward matter of delivering what the service level agreement specified. The key difficulty for SUPPLIER A was of course that they were taking over from an existing contractor that was used to CLIENTCO’s idiosyncrasies and expectations. For SUPPLIER A it was a new environment. There was no one whom they could initially rely on to help operationalise the contract, especially not SUPPLIER B, the competitor, who had lost the business. Surprisingly,
CLIENTCO’s managers were initially not aware of these difficulties. Only in retrospect did they recognise the correlation between their idiosyncrasies and SUPPLIER A’s early problems:

“It was a difficult time because they didn’t know how we worked, we weren’t saying to them, ‘here’s five of our best people, they are going to sit and work with you’, because we didn’t have five people to work with them. Because the business had already been contracted” (Senior Manager, CLIENTCO).

CLIENTCO’s experience with procuring services informed this policy of adhering to service levels agreed. In turn, CLIENTCO had invested considerable time and effort on formulating a detailed contract and service level agreement, that then had to be delivered on:

“It’s all laid down in here [the contract]. The systems are all defined as being either critical, highly critical, or low criticality. They are graded according to how critical they are to CLIENTCO and the business. And depending on whether they are critical or less critical it defines how many hours you can wait before you get a problem fixed.” (Application Support Manager, Supplier A).

The service level agreement (SLA) detail also simplified the payment system. All payments were dependent on the achievement of the stipulated services. Non-accomplishment in any way inherently invoked conflict and, more importantly, provoked the loss of any achievement bonuses. Evaluation occurred on the basis of three main performance measures: down time, the number of change requests, and the amount of time spent on specific aspects of the core services. The core service levels and their prices were annually renegotiated and updated, in an effort to ensure that costs were continually reduced, and the legacy services slowly phased out.

The transition period also revealed CLIENTCO’s strong corporate culture for the first time, to which SUPPLIER A would need to adjust speedily. It was CLIENTCO’s practice to impose its culture on any supplier wishing to do business with them. In the period of consideration their culture had a strong focus on security, safety and control. In part this was due to CLIENTCO’s parent company, but it also emerged from the nature of their business. Working with CLIENTCO was seriously complicated by this security, safety and control driven culture. The resulting controls also increased the operating costs for the supplier substantially: “We’ve had a number of suppliers tell us that our controls potentially add 25% to the cost” (Vendor Manager, CLIENTCO).

These early adjustment and cultural difficulties led to an initial poor service performance. This, of course, seriously hampered the development of the relationship. CLIENTCO’s control culture did not help in this case either. Managers were out to find the source of these difficulties. Blame was later to be apportioned to both CLIENTCO’s and SUPPLIER A’s operation managers in charge of the deal. To resolve the issue, they had to be replaced, due to ongoing confrontations. These changes were very costly for both SUPPLIER A and CLIENTCO. However, this change in structure was to be critical for continuation. Indeed, later, it was perceived to be a defining moment in the turnaround of the venture and relationship.

Part of the newly appointed relationship managers’ remit was to ensure SUPPLIER A’s structure, and hence managers, were closely matched to the client’s expectations of a good interface and contact point. In this respect, CLIENTCO relationship managers became much
more involved in all personnel arrangements, and in the alignment of SUPPLIER A’s structure with that of CLIENTCO’s. In any case, the decision to formalise the structure was to influence the growing amount of time managers spent on the relationship rather than just focusing on the business requirements. It became indicative that IT outsourcing success was correlated with relationship management: ‘The contract takes up 25% of our time and the rest of it takes 75%’ (Relationship Manager, CLIENTCO).

However, effective relationship management depended even more so on management processes. Yet CLIENTCO had taken the management procedures and processes from its previous dealings with SUPPLIER B and merely applied these to the operations with SUPPLIER A. It soon became evident that these would not work with SUPPLIER A. Consequently, during the far-reaching changes to the management structure in 1995-96, several of the management processes in terms of reporting had to be addressed. With the interaction structure already redefined, CLIENTCO then formalised its management processes, outlining particular meetings at which supplier performance would be reviewed and according to which payments were then made and bonuses granted. These meetings were key to CLIENTCO’s control agenda, and gave both senior, operations and functional managers an opportunity to closely monitor supplier performance. Additionally, the meetings provided the possibility for voicing any concerns or problems that had arisen and drawing senior management’s attention to them. The evolving management process included adhoc meetings, and formalised inter-organisational quarterly, monthly and weekly meetings at different levels.

**Forced to Renegotiate the Contract (1996)**

Towards the end of 1995 it had become clear to SUPPLIER A that they were no longer able to deliver the services as originally priced and agreed. For the first one and a half years they had only made losses. The contract was in fact costing them significant amounts of money. In consequence services were suffering, and both sides were highly dissatisfied with the arrangements. As a result SUPPLIER A was forced to re-evaluate the contract and its business with CLIENTCO. In part, they had to admit to themselves that some of the problems they were encountering, especially the lack of profit, was a result of their erroneous calculations and assumptions about CLIENTCO’s business. However, this only became apparent to SUPPLIER A during the actual operationalisation of the contract:

“When Supplier A first came into the frame with us they were very much used to dealing with public utilities and councils and things like that and they found us very strange. They came in, they took our business and they made some assumptions that we were organised like a council or a utility. We had high overheads, all those sorts of things. We had excess resources working in that area. But we didn’t. We’d already done all that work. They were a little bit naive to start off with” (Vendor Manager, CLIENTCO).

Consequently, in mid 1996, SUPPLIER A was left with few options but to confront CLIENTCO with their partially self-inflicted problem and request an early contract renegotiation. Essentially they had two real options for resolving the situation: either renegotiate or terminate the contract early. CLIENTCO’s response was favourable, revealing a sympathy and understanding of the supplier’s situation. The stated position was that they were not interested in causing SUPPLIER A a loss and wanted both parties to mutually benefit from the deal. Hence CLIENTCO’s management agreed to revisit and evaluate the original contract. Interestingly, they found terms
and price scales that essentially prohibited SUPPLIER A from making an adequate return on their costs. Reflecting on the original state of the contract one respondent emphasised:

‘the contract that was put together was appalling. It did not take into account the availability of additional programmers as needed and the very significant price rises in the market. This thing wasn’t tied to KPI’s (Key Performance Indicators), it wasn’t fair, they just couldn’t deliver the services for us on it, so we had to go in and make some changes’ (Vendor Manager, CLIENTCO).

The procedures adopted for the renegotiation cycle were simple. Whilst the ongoing service delivery was continuing as specified in the initial contract, a team on Supplier A’s side was formed which negotiated the specific changes with CLIENTCO’s Contracts and Materials department and the CLIENTCO Vendor Managers. The ensuing review and renegotiation re-aligned, for example, the contract to the present and actual service demands, and also uncovered a number of stipulated terms that were unenforceable in business terms:

‘There was a review on how much they were paying for core services because we were doing a lot more core work than we were being paid for at the beginning […] but also there just seemed to be a lot of unnecessary stuff in the contract which we were never going to try and do. It didn’t seem to make business sense to do it. So that was taken out’ (Applications Support Manager, Supplier A).

Once a section had been renegotiated and finalised, the changes were then taken on board straight away by SUPPLIER A’s account team and CLIENTCO’s operational managers. This meant direct implementation and operationalisation of the new terms. At times, the renegotiation phase was a trying time and relations suffered, but it was an essential process if SUPPLIER A was to be able to continue with the outsourcing venture.

The outcomes of the renegotiation were felt to be a very positive experiences for both parties. At least it ensured mutual benefit from the deal for the future:

‘I think to a certain extent we’ve both ended up walking away from that saying yes we are happy with the result. They are not getting everything they wanted, and we are not getting everything that we wanted’ (Vendor Manager, CLIENTCO).

Rebuilding Relations - Post-Contract Renegotiations (1997 onwards)

The successful outcome of the renegotiation phase put the relationship back on track. First signs of the changes to come were the dramatic service performance improvements. These were so impressive that in subsequent months relations improved to such a degree that both parties agreed to develop the basis for a partnership agreement. This agreement would cover a number of operating principles, but would not embody any legal commitments whatsoever. Instead it was a rhetorical commitment:

‘It’s an informal thing but it’s been written by both sides. We have a partnership agreement with them rather than just do this only and only this [contract]. But I don’t think it’s actually officially recorded anywhere. It’s one of those things that Supplier A and CLIENTCO do
mention a few times, we are trying very hard to work with CLIENTCO not against them’ (Application Support Manager, Supplier A).

The informal agreement was based on greater commitment by the supplier to inform CLIENTCO of any planned changes that could effect the relationship. In a sense, it was an extended promise to cooperate and collaborate more closely. The impact of this informal agreement was manifold. For one thing, it increased willingness for closer cooperation and generated a feeling of openness and trust in each other. Both parties managers consciously worked on fostering such an environment as they not only believed in it, but also wanted to ensure each other’s awareness of any difficulties or problems:

‘I trust them to speak to me if ever they need anything or want to tell me anything. I think I’ve more or less achieved that they will phone if they’ve got the slightest need to talk. I also want to make sure it’s a very informal relationship. That’s developed quite nicely, they don’t feel inhibited, they will call if they need to’ (Operations Manager, CLIENTCO).

The result of these developments spurred a strong sense of loyalty on the supplier’s side towards CLIENTCO. In fact, the loyalty evolved to define an ethical undertone in the operations of the venture. The benefits of these changes were felt to be of mutual advantage. In SUPPLIER A’s case it gave rise to new opportunities for business with the IT department but also with other customers, i.e. a range of business units within CLIENTCO. Another benefit for SUPPLIER A was the client IT group’s willingness and openness to discuss their future developments and long-term strategy. It gave SUPPLIER A the much sought opportunity to bid early for new and upcoming business services CLIENTCO needed. This ensured the ongoingness of their relations as well.

On the other hand, the benefits for CLIENTCO were increased access to technology, expertise and skill resources, enabling them to implement projects faster and move their business forward. More importantly, CLIENTCO began actively to seek value added by offering an additional bonus award if SUPPLIER A could show they had implemented additional innovations that added real value or generally improved CLIENTCO’s operation.

Strong signs that the relationship and hence operations had improved became apparent in early 1998. Service levels were in line with CLIENTCO’s demands and in most cases even exceeded stipulated services. Their service performance record was exemplary, giving raise to considerable bonuses. The operations manager from CLIENTCO explained that:

‘It’s quite an incentive to be given that bonus for consecutive months. And just recently I think they went for 7 consecutive months where the batch bonus was paid which was quite an achievement. Because that’s a long time to go, a whole month without anything happening.’

The relationship continued on this basis for next two years until its contract end. In 2001 the venture was in its second five year contract period, having never looked back after three traumatic IT outsourcing years.
6. Strategies To Avoid Experiencing A Relational Trauma - Lessons Learned

Before deriving the lessons learned from this case, it is useful to establish how widely applicable these lessons might be. We detailed earlier the conditions and circumstances in which a Winner’s Curse can arise. We also argued, from the research literature, and our own research experiences, that the Winner’s Curse is quite common, suggesting that the lessons learned from this case, are, not least through analytical generalization, highly pertinent to all contemplating or participating in IT outsourcing arrangements. Let us reinforce this point by re-analysing from a Winner’s Curse perspective one of the richer empirical sources available on IT outsourcing, consisting of a detailed longitudinal case research database

The research we will re-analyse examined at 85 IT outsourcing arrangements across the 1992-2000 period. In Figure 2 we chart our re-analysis of these IT outsourcing deals in terms of the impact of the original bids and contracting terms. Firstly, it can be seen that the supplier experienced a Winner’s Curse in nearly twenty percent of the cases, while the client experienced a negative/mixed impact in nearly 36 percent of the cases. Clearly the Winner’s curse, and ‘cursed’ clients, are by no means rare phenomena

Secondly, our re-analysis confirms that the left-hand quadrant IS a very risky place to be. Of the 12 deals, seven terminated early, one was terminated and restructured, one was not renewed, and three continued for differing reasons but were viewed as persistently problematic by all respondents.

Thirdly, it is noticeable that where a supplier experiences a Winner’s Curse, there is a high likelihood of this affecting the client negatively also. There were three cases where this was not the case (top right quadrant of Figure 2). Two, involving a major UK retailer and an aerospace company, saw the supplier eventually move into profit as more work came on stream after the fourth year of these ten year deals. The third was a public sector agency whose gains on an economic development package with the supplier came to be offset by the cost increases in the IT service aspects of the deal. In all three the suppliers succeeded in removing the Winner’s curse, and moved into more profitable ways of operating. Fourthly, and unsurprisingly, the bottom left-hand quadrant is not a stable place to be either. While ten deals did continue to their natural term, though producing very mixed results for the clients, four others were terminated early, three were renegotiated, and two saw a degree of ‘backsourcing’ - the slow rebuilding of in-house capability during the course of the IT outsourcing contracts.

By definition, the successful IT outsourcing cases fall into the bottom right hand quadrant of Figure 2. What is most noticeable here is the high propensity of clients to subsequently renew contracts with the same supplier – over three quarters did so – and the disproportionately high number of selective outsourcing deals on 3-4 year terms with detailed contracts and SLAs. But
how can stakeholders in IT outsourcing ensure they can get into this quadrant, or – more difficult – if an outsourcing deal does not start out here, what can be done to turn the situation around? Our case helps to provide some possible answers here. The case highlights clearly the potential impact of a Winner’s Curse on post-contract management operations. Here we will now outline what we found to be the key lessons on how to avoid experiencing relational trauma, increase in most costs, loss of service performance, and increase in dissatisfaction amongst the end-user community.

Strategic Lesson 1. Suppliers bidding for an IT outsourcing contract may underbid because they do not take into account the real value and real costs of the outsourced activities and they do not take into account a correction for their own optimistic estimate because their bidding aim is to win the deal.

The initial deal CLIENTCO negotiated was strongly in its favour, but the relationship as such was ‘cursed’. The deal as agreed, gave SUPPLIER A all too few possibilities to recover their bidding expenses and negotiation costs. In fact, SUPPLIER A found that the venture would make a net loss to operationalise, as they had evidently mis-calculated their initial bid offer. It is interesting to examine how SUPPLIER A could have made such an erroneous cost calculation when competitively bidding for CLIENTCO’s business. The conjecture proposed by the managers at CLIENTCO seemed quite plausible - that SUPPLIER A had made assumptions about CLIENTCO’s high resource base costs and operational inefficiencies, and then was unprepared to find that CLIENTCO for the past years had been on a drive to minimise costs and rationalise, standardise and downsize operations where possible. However, there is another plausible explanation, which in other documented cases such as the Inland Revenue, British Aerospace is also evident. SUPPLIER A needed to contract with CLIENTCO to gain credibility, prestige and references by working with a major Blue Chip organization. To SUPPLIER A, essentially a small niche supplier, such a deal held widespread perceived benefits beyond solely making a margin on that contract. A third contributory factor was that the bid team was largely different from the group that was charged with operationalising the contract and was rewarded on a different basis – on securing the contract, not on operational performance. The learning points would seem to be:

- Analyse carefully the reasons for, and the detail of, a low supplier bid, and whether the bid can result in a reasonable profit for the supplier.
- The supplier and client should ensure that those operationalising the contract are influential in the vendor selection and bidding process.
- Reassess the cost/service baseline before outsourcing, and make detailed disclosure to the bidders(s).
- Fixed price contracts will create inflexibilities, possibly disadvantageous to both parties. In fact there is a considerable literature pointing out the typical problems experienced with fixed price contracts even in the IT outsourcing field. Consider flexible pricing options including cost plus, market pricing, fixed fee adjusted by volume fluctuation, benefit sharing. Track supplier costs via ‘open book’ accounting. Allow for biannual assessment of pricing adjustments.
- Undertake a rigorous due diligence process before the contract is actually finalized.
Strategic Lesson 2. A Winner’s Curse for suppliers can result in a negative impact for the client resulting in relational trauma, renegotiation costs and end-user dissatisfaction or in a positive impact for the client when the supplier incurs the losses and delivers the services to the agreed levels.

Its miscalculations cost SUPPLIER A dearly in the initial one and half years, to such a degree that they were left with no other option but to ask for a early renegotiation. At this stage, CLIENTCO could have responded by emphasising that SUPPLIER A needed to honour the contract or pay a termination fee, but they were not interested in going down a track of complete relational failure and possible high media publicity, and instead decided to renegotiate the contract. This renegotiation proved beneficial for both parties, as services improved considerably and SUPPLIER A in parallel was beginning to make a marginal return. The case emphasises that a balance needs to be struck between service levels and costs. The goal must be win-win, where the supplier can make a return. In a one-sided venture, the supplier has to try to cover its costs in any way possible, which is likely to effect services, operations and relations adversely. In addition, in situations of competitive bid circumstances the client generally has to ensure that the supplier is fully aware of the extent of the service requirements, and the client may have to spend more time on evaluating the bid proposals to avoid having to invest in costly renegotiations after such a short period of operation. The learning points are:

- An outsourcing contract will rarely be delivered satisfactorily where the supplier stands to make a loss, because this will tend to have detrimental effects on the service delivered and sour what could otherwise be a synergistic relationship.
- Renegotiation and restructuring may be better options than termination and high switching costs (see below).
- Conceive the bid as about a relationship over time, rather than a one-off win or loss.

Strategic Lesson 3. Relational trauma in IT outsourcing can be overcome by initiating early contract renegotiations. Such a strategy will change service performance, the nature of the relationship, impact the management structure, and improve operational efficiency.

Significant impacts on post-contract management and operations were identified in areas of contract achievement, management structure, relationship atmosphere, and operational efficiency.

Contract Achievement
Unexpectedly for CLIENTCO, service levels plummeted significantly during the transition period. They remained below target and satisfaction levels for over a year. End-users commonly expect that the supplier comes in and services then improve dramatically, not least where there is pent-up demand from previous cost containment, as at CLIENTCO. Often these expectations are not achieved and rather take an unexpected downturn. CLIENTCO’s case is no exception here. Adjusting to new processes, systems, corporate cultures takes time. As the customer service manager from Supplier A noted:

“the specific stage when the trust went down is when we started, and it's extremely hard to provide a service, whatever the level of personnel is, when you don't understand the systems. Obviously systems are very different within different companies. Technology is the same and ideas of how systems work are the same but the actual specifics are very different. So when
you come in cold and start to provide the service from nothing then the user will see a dip in their service from the previous supplier to you.”

However, contract achievement was always going to be very difficult, as again SUPPLIER A had made a number of assumptions about CLIENTCO’s operations and requirements that, actually, did not apply; especially in terms of rationalisation and standardisation. It is plausible to assume that SUPPLIER A was not fully aware of the systems and applications they were to take over and more importantly possibly lacked some of the competencies and resources to actually deliver CLIENTCO’s service levels. The degree of miscalculation made by SUPPLIER A seemed to corroborate this fact, as did the lengthy period for the actual consolidation and eventually transfer of the systems to SUPPLIER A’s headquarters. This emphasizes once again the importance of the customer evaluating the suppliers resources, skill-sets, and assumptions regarding their business.

Management Structure
Selective outsourcing for cost containment on a relatively short term contract is not commonly associated with detailed relationship management considerations - due to the typically stable IT activities and contractual clarity of what is outsourced. In CLIENTCO’s case, though, active relationship management became critical. The evidence suggests that due to the Winner’s Curse scenario in the deal, the supplier was probably not willing to resource the venture with its most experienced managers - as a small niche supplier it most likely needed them as a sales team to attract new business. In turn, during the first year the existing account manager found it very difficult to pick-up from the previous supplier and turnaround the relationship. His problems in managing the relationship led, instead, to loggerheads with the client’s manager. Therefore CLIENTCO requested a new manager, who would then face off against two newly appointed relationship managers. The reason being that SUPPLIER A obviously needed more active management. This was a decisive step to save and turnaround the venture.

The impact of a soured relationship, and consequently having to change the management team at such an early point, was very dramatic. In many ways it meant starting all over again in developing rapport and relations. For SUPPLIER A though these changes meant improved cooperation and support in helping them to adjust to CLIENTCO’s idiosyncrasies.

Relationship Atmosphere
The case seemed to highlight a relational development from a strict contract controlled environment to a more trusting and cooperative environment. It is in the nature of the way CLIENTCO apparently operates that they generally endeavour to control operations:

“As far as we were initially concerned a supplier is a supplier, and we've gone out and asked them to provide X and if they don't provide X then we are going to hit them over the head until they do provide X” (Vendor Manager, CLIENTCO).

Their extensive experiences with procuring products and services from the market led them to adopt a power wielding approach. In retrospect, management by contract and the expectation to deliver according to contract reflected this culture. However, is this an appropriate approach in IT outsourcing? In this situation the control approach failed and led to the breakdown of relations. What SUPPLIER A needed initially was some guidance in understanding CLIENTCO’s operations. The parties needed to worked together to clarify the requirements and idiosyncrasies
of CLIENTCO and this was clearly missing. The results were evident in the amount of conflict between account managers. Effects were disastrous for both parties. Service levels were low and SUPPLIER A was losing money.

Improvements came with the introduction of the vendor managers who seemed to be interested in helping and cooperating to ensure both parties mutually benefited from the venture. In fact, CLIENTCO’s managers quite deliberately focused their initial efforts on resolving SUPPLIER A’s problems with CLIENTCO, and so began to build trust. Cooperation between the parties was to become fundamental and it is plausible that only in this kind of context did SUPPLIER A gather sufficient momentum to actually approach CLIENTCO to request an early contract renegotiation. The developments following the renegotiation were remarkable considering that the relations had broken down. Literally 18 months later, the parties had informally agreed to a partnership and managers from all levels were engaged in team building exercises. The environment fostered by cooperation and working through problem issues was one of openness and trust, yet the contract was still governed the deal.

**Operational Efficiency**

The lack of a reciprocal profit for SUPPLIER A contributed to the deficient services levels. Only through early renegotiation in 1996 was this alleviated, which of course introduced considerable extra costs for both parties in terms of time, resources to renegotiate, and subsequent development of a renewed rapport and relationship. This raises serious questions over whether CLIENTCO truly made a cost saving that year, and for the venture in general. We can assume that no matter how long contract renegotiations take it will be at significant costs to both parties. Nevertheless, the renegotiation process assured that both parties eventually made a return on the venture and saved SUPPLIER A from having to terminate the contract which undoubtedly would have been disastrous in terms of costs for both parties. As a matter of fact, the renegotiation helped improve relations to such an extent that other value added benefits have since emerged from the venture not only for CLIENTCO, but also for SUPPLIER A, and in the long-term CLIENTCO’s operational efficiency improved. The learning points would seem to be:

- The need for early end-user expectation management on the client side, especially during the transition period.
- Ensure that the contract management culture is conducive to supporting superior supplier performance.
- Review the in-house core management capability and skills needed for managing external supply. Consider building informed buying, contract monitoring, contract facilitation and vendor development roles from the beginning of the contract. Otherwise problems will arise making them necessary.
- There is a relationship dimension to every IT outsourcing deal that no contract cannot substitute for. Ensure it is managed to advantage.

**Strategic Lesson 4. A Winner’s Curse can be avoided by a supplier through information gathering and bidding activities.**

The case findings identified a number of issues that a client organization can influence in order to avoid or at least minimise the impact of a ‘Winner’s Curse’ (see Figure 3 below). In line with general outsourcing practice these considerations would filter into a client organization’s
evaluation, selection and negotiation strategy. The objective has to be control of the impact on post-contract management and the relationship.

Figure 3 about here

**Figure 3 – Supplier Perspective On The ‘Winner’s Curse’**

In the case, it was evident that SUPPLIER A suffered from having insufficient information to make an adequate assessment of CLIENT A’s requirements. The problem clearly was that SUPPLIER A was under time pressure to make an offer for a set of services that for the past seven years had been delivered by SUPPLIER B. The existing supplier knew exactly what the service provisions would entail, whereas SUPPLIER A had to rely on information only partly made available by the client and the direct competitor. The resulting assumptions underpinning the SUPPLIER A’s bid was based on incomplete, incorrect and outdated information. In terms of transaction cost theory, there is likely to have been an information asymmetry, resulting in specific knowledge concerning service specifications being fragmented and the free flow of information hampered leading to information impactedness. Client organizations in turn have to ensure that no such information impactedness exists, at least, in terms of their detailed service requirements. The danger, as highlighted in this case, is missed service and technology operations that should have been part of the supplier’s bid and for which the supplier has not calculated any resources.

A mis-aligned bid will entail either a) termination, b) supplier’s opportunistic behaviour (potentially damaging the client), c) the supplier accepting the loss and supplying the agreed service for strategic reasons, or d) renegotiation. In the case SUPPLIER A could not achieve b) at a profit, did not want c) so offered a) or d). Clearly the client could have played a more active role in evaluating the bid suppliers make, especially in one-to-one competitive bidding circumstances, to prevent possible miscalculations of the baseline costs. Interestingly, the client culture of cost efficiency and tight control was perceived as a protection, but ultimately backfired to produce undesired results. Client organizations should ensure that suppliers have a reasonable profit margin in their deal, or else the focus on the supplier’s operations will be solely on where it can recover its bidding costs and begin to make a margin. Otherwise, as partly happened in the case, a supplier will seek to save on resources and employ inexperienced managers that diminish client users satisfaction levels.

Although, the case did not provide direct evidence, there was an issue that SUPPLIER A was confronted with a legacy system where it did not have the skills and resources to effectively handle the service and system requirements of CLIENT A. A potentially dangerous situation, as the supplier may have to recruit resources and the capabilities from the market before it can provide the actual services. Again the client should take an active role in determining whether the supplier is sufficiently resourced in terms of capabilities and skills to handle the deal. The fundamental lesson would seem to be:

- Supplier information gathering activities are vital. The client should check to ensure that the bidders are undertaking the detailed information gathering activities necessary to present a bid that will be effective in operational terms.
Strategic Lesson 5. The Winner’s Curse can be avoided by clients by detailed information provision, by building-in contingencies in the contract, and via a choice of the format of the bidding arrangements.

The bidding phase is often a one-sided event, and may actually demand a more active participation of the client. We have made this clear already, especially in terms of assessing the supplier’s overall resource potential, capabilities, skills, information access, bid offer and cost calculations. Intervening early on may prevent the experience of a Winner’s Curse for both parties and subsequent adverse impact on the relationship.

A second factor is the choice and specificities of the bidding arrangements. A key question for bidding arrangements is whether to use a single round or a multiple round sealed-bid format. The critical distinction between formats is that a multiple round scenario provides the bidders with information through the process of bidding. This information often turns out to be a double-edged sword. It may stimulate competition by creating a reliable process of price discovery, by reducing the Winner’s Curse, and by allowing efficient aggregations of items. Alternatively, the information may be used by bidders to establish and enforce collusive outcomes. Ex ante asymmetries and weak competition – as in the case – favour a single round, sealed bid design. In other cases, a multiple round bidding arrangement is likely to perform better in efficiency and revenue terms.

For the client organization some lessons would seem to be:
- Assist the supplier with the information pointed to in Strategic Lesson 4.
- Maintain initial tight control but work flexibly where contract and service metrics are outrunning market prices;
- Check market prices regularly and build price recalculations into the contract;
- Consider carefully the bidding format. In different circumstances a single round or a multiple round sealed bid will be more appropriate.

Strategic Lesson 6. For a customer to establish its preferred contract mode, we suggest identifying the relationship it implies and how these, and their staffing, support the service and value-added it expects to receive from a supplier.

The case evidence allows us to reconsider IT outsourcing in a more fundamental sense. Distilling findings from a number of previous studies, a strong relationship exists between the strategic intent a client organization chose to pursue, the kind of technical capability it needed to employ, and the type of relationship needed to match intent and supplier capability, and achieve expectations. A strong finding has also been that there are frequent misperceptions on the part of all parties as to the nature of the relationship, and what can be expected from each other as a result. Let us, firstly, classify the types of relationship we have observed, then illustrate, through examples, the importance of getting strategic intent, technical capability, and relationship definitions aligned.

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Figure 4 about here
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Figure 4 – Strategic Intent and Capability in IT Outsourcing: Identifying Relationships

The main types of IT outsourcing relationships are classified in Figure 4. Here strategic intent, in terms of expectations from outsourcing, is divided into whether the focus is on achieving business value and/or on achieving IT efficiencies. On the horizontal axis, technical capability refers to choosing to externally source to gain a distinctive technical leadership, or to gain access merely to technical resources that form a resource pool not otherwise available to you, in cost per quality terms. The matrix sets up four possible relationships. By far the most common is the ‘Technical Supply’ relationship where the objective is to achieve IT efficiencies by hiring external resources. In such a relationship the fundamental focus is on cost minimization, and the rendering of IT as a variable cost. As at CLIENTCO, the major debates will centre around the cost-service trade-off, and measurement systems will also be constructed around this.

Another possible relationship we call ‘Business Service’. Here the objective is to use an external IT supplier who can improve service to the business by not only delivering more precisely on changing business requirements, but also by, for example being involved in business process improvement projects. Here the contract will be about both IT efficiency for business impact, and the supplier’s contribution to business improvement. Here one would expect additional processes and relationship mechanisms for involving the supplier more closely in business issues. The evaluation debate would be more on business value and suitable metrics, based on the business impact of supplier performance. In this respect it is interesting to note that on some figures business process outsourcing may reach $US14.7 billion in revenues in 2002.

A third type of relationship is ‘Technology Partnering’. BP Exploration (BPX), for example, in their 1993-98 outsourcing deals, explicitly chose three suppliers because they had ‘best-in-class capability in particular areas. BPX expected future-proofing on the technological front, with the suppliers keeping BPX abreast of leading edge technology, and also pro-actively innovating in technologies and their application to BPX.

Finally, all too many large-scale outsourcing arrangements are presented as ‘Strategic Alliances’. For us such an alliance assumes a working together to make offerings to the external marketplace, and sharing the risks and rewards of such endeavours. The focus here is on business expansion, the main debates will be around business goals, mutual contribution and shared rewards. Several authors found many so-called strategic alliances in IT outsourcing to be largely fee-for-service contracts; moreover the risk-reward elements were too small a part of the relationship to make a difference in terms of motivation and focus.

Clarifying these options, and when they are most suitable, is an important pre-condition for establishing the right relationship mechanisms and evaluation regimes. In practice we have seen all too many organizations contract and manage tightly for cost efficiency, but then also expect the sort of business value-added that could only be got from a ‘Business Service’ relationship, or the technical innovation and pro-activity that could only be provided through ‘Technology Partnering’. This partly explains why BPX was disappointed with at least two of its 1993-98 suppliers. In another way, in the $2 billion plus BAE-CSC 1993 ten year deal, B Ae managed CSC tightly though the deal ostensibly had ‘Business Service’ and Technology Partnering’
components. It was only after several years, and after CSC had made large investments in making the IT function efficient, that BAE managers started being interested in allowing CSC to tap the other possibilities for revenue.

Cultural and financial factors often drive these misconceptions. Early on in BPX traditional cost reduction approaches prevailed in the deals though the deals had been paraded as more about technology partnering. At the same time, for example, a supplier, as at CLIENTCO, will find it difficult to sustain a ‘Business Service’ or ‘Technology Partnering’ orientation if the money is not going to be there. Sometimes it is lack of the right kind of partnering capability, in either or both client and supplier, as at CLIENTCO. More frequently there is a lack of clarity at the scoping and evaluation phases of IT outsourcing, to identify precisely which components require what metrics and what relationship arrangements.

Given these considerations we offer the framework in Figure 4 as a way for a client to think through exactly what he/she is trying to achieve with different parts of its IT outsourcing, and what the implications of this analysis might be for relationship arrangements and assessment regimes. On this, the learning points from CLIENTCO would seem to be that:

- Even a ‘Technology Supply’ outsourcing arrangement needs to be staffed and managed for its relationship dimension, not least to build in the necessary flexibility where the contract is designed poorly to deliver on stakeholder intents.
- A ‘Technology Supply’ arrangement will inhibit severely the probability of the value-added inherent in the other three forms of contracts and relationships.
- However, as in CLIENTCO, if the right core IT capabilities are in place, the relationships developed in a ‘Technology Supply’ arrangement can lead to further opportunities for enhanced benefits in any of the other three outsourcing regimes.

7. Conclusions

This paper made four distinct contributions to our understanding of IT outsourcing practice. First, we identified the phenomena of a Winner’s Curse and explicated it in the bidding context for an IT outsourcing contract. The danger of suppliers bidding to win irrespective of calculating for a profit margin, was shown to have strong similarities to what auction theory identifies as a Winner’s Curse. Second, we show, from a re-analysis of 85 extant IT outsourcing cases, how common and problematic a Winner’s Curse, as we have explicated it, has been in IT outsourcing, and locate the findings of the CLIENTCO case as part of this phenomenon. Third, the detailed case history allowed for clear development of six strategic lessons. These lessons address the impacts of Winner’s Curse for clients and suppliers and the strategies to overcome and more importantly present experiencing a relational trauma in an outsourcing deal.

The experience of a Winner’s Curse was shown to pose considerable pressures for an outsourcing venture and the relationship, to the extent that re-negotiations, or even early termination, becomes the only and best option. Active relationship management by competent relationship managers who can facilitate a successful and mutual turnaround of such a venture in these contexts takes on a new meaning. Regardless, though, of whether the venture and relationship is saved, significant costs will arise for both parties, raising general doubts over the financial viability of such deals in
general. However awareness and understanding of how such scenarios can evolve is starting point for avoiding a winner’s curse experience.

Fourthly, we propose a more complex and subtle view of IT outsourcing relationships than typically analyzed in the management literature. For this, the paper provides new scenarios in IT outsourcing and new directions for inquiry for managers and researcher of IT outsourcing. Thus the paper describes different IT outsourcing scenarios and identifies different strategies for clients and suppliers to cope with the Winner’s Curse and avoid relational trauma. The paper also highlights new questions for research. As one example, can we create specific tendering designs that are likely to be successful for IT outsourcing bids? We also provide a typology of types of relationship as a diagnostic tool for further research, and to help practitioners analyse their own deals and perceptions.

A limitation of the paper is its focus on a sole longitudinal case study to develop the lessons and figures. A broader study of a number of cases would be of clear advantage, although we have, in fact, addressed this issue to a degree by re-analysing published work that proved rich and detailed enough for us to draw some conclusions about the prevalence of ‘cursed’ IT outsourcing arrangements, and their subsequent dynamics, and how the CLIENTCO case helped to illustrate these dimensions.

Finally, as the Internet evolves into a powerful and reliable infrastructure for electronic commerce and electronic business, new configurations are possible and feasible. Application Service Provision (ASP), for example, is seen by companies as a potentially profitable business model. In these new configurations relational trauma might occur, and this paper identifies some major lessons that client and supplier companies should consider before signing netsourcing contracts.
Figure 1: The Winner’s Curse and Other Scenarios in IT Outsourcing
Figure 2 - Prevalence of the Winner’s Curse in IT Outsourcing (85 cases re-analysed from published sources)
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<th>CAUSES</th>
<th>ADVERSE CASE OUTCOMES</th>
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<td>INFORMATION IMPACTEDNESS</td>
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</tr>
<tr>
<td>• Misaligned bid offer</td>
<td>NO POSSIBLE PROFIT MARGIN</td>
</tr>
<tr>
<td>• Bidding to win, no matter</td>
<td></td>
</tr>
<tr>
<td>• Under-estimate of resources and capabilities required</td>
<td></td>
</tr>
<tr>
<td>• Under-estimate of rigidity of contract</td>
<td></td>
</tr>
<tr>
<td>c) <strong>Operating</strong></td>
<td>REVENUE ENHANCEMENT</td>
</tr>
<tr>
<td>• Over-estimate of extra work and excess fees available.</td>
<td>TACTICS CURTAILED.</td>
</tr>
<tr>
<td>• Under-estimate of control and tightness of client contract management</td>
<td>OPPORTUNISTIC BEHAVIOUR MINIMISED.</td>
</tr>
</tbody>
</table>

**Figure 3 – Supplier Perspective on the ‘Winner’s Curse’**
<table>
<thead>
<tr>
<th>Strategic Intent</th>
<th>Business Value</th>
<th>IT Efficiency</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>“Business Service”</td>
<td>“Technical Supply”</td>
</tr>
<tr>
<td></td>
<td>• Underpinning Business Requirements</td>
<td>• Cost/Service trade-off</td>
</tr>
<tr>
<td></td>
<td>• Supporting Internal Business Improvements</td>
<td>• Cost Minimization</td>
</tr>
<tr>
<td></td>
<td>• Pay-per-Supply and on Business Results</td>
<td>• Pay-per-Supply</td>
</tr>
<tr>
<td></td>
<td>“Business Alliance”</td>
<td>“Technology Partnering”</td>
</tr>
<tr>
<td></td>
<td>• Profit Generation</td>
<td>• ‘World-class’ Capability</td>
</tr>
<tr>
<td></td>
<td>• Competitive Edge/Strategic Contribution</td>
<td>• Innovation/Development</td>
</tr>
<tr>
<td></td>
<td>• Shared Risk/Reward</td>
<td>• Technology Risk Sharing</td>
</tr>
</tbody>
</table>

‘Resource Pool’ ‘Distinctive Technical Leadership’

**Technical Capability**

**Figure 4 – Strategic Intent and Capability in IT Outsourcing: Identifying Relationships**


Williamson’s (1975) noted that social actors will behave opportunistically if it is advantageous for them to do so. This opportunism denotes the capability and willingness of organizations to pursue their own interests at the expense of partners by withholding, for example, information. Williamson, O. E. (1975). Markets and Hierarchies: Analysis and Antitrust Implications, A Study in the Economics of Internal Organization. New York, The Free Press.


Ibid 14


Ibid 16 Klemperer


This point is made by one of the anonymous reviewers and we greatly thank him/her for this suggestion.


ibid 14 Cross


ibid 6 and ibid 4 Lacity and Willcocks


Lacity, m. and Willcocks, L. (2001) ibid.

See Lacity and Willcocks (2001) ibid. The authors make available the case study data on an open website. It is this database that we draw upon here, together with details of the cases from the written published sources. The latter are rich enough to permit an analysis of the initial deals, and of subsequent outcomes. The references to the academic papers and the website will be made explicit in the final version of any published paper.

Ibid 20 Willcocks and Kern

Ibid 6 Kern and Willcocks


Similar as the discussion in sales auctions on the difference between a multiple round, ascending auction and sealed-bid auction, see Peter Cramton (1998), Ascending Auctions, European Economic Review, vol.42, 745-756.

Ibid 1 Lacity, M and Hirschheim, R., and ibid 26 Ang and Straub.