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Ralph DeFrangesco
Aetna Inc.

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Ralph M. DeFrangesco
Aetna Inc.
defrangescor@aetna.com

ABSTRACT

This paper gives an outline of the various outsourcing models and provides information that every company considering outsourcing should know. A case study of the EDS/GMAC Mortgage outsourcing agreement is included.

Keywords
Outsourcing, outsourcing models, co-sourcing

INTRODUCTION

According to Culpepper (2006), a global survey company, 16% of U.S. Companies plan to outsource business functions in 2006. This is up 5% over 2005. As industries push toward a stronger bottom line, outsourcing is an increasing way of business life.

This paper examines the various outsourcing models and provides information that every company that plans to outsource should know. A case study of the EDS/GMAC Mortgage outsourcing agreement is included.

CURRENT OUTSOURCING MODELS

Outsourcing could be defined as the contracting out or selling of an organizations software assets, people and activities to a third party supplier. Some examples include Information Technology services, product manufacture, research and development activities, and customer support.

Figure 1 shows two project types, a small defined project and a large infrastructure project. The decision point on who to outsource to is based on time. Outsourcers typically like large, multi-year, operational type contracts. A small defined project might only require a basic contract where a large infrastructure project will require more of a complex contract (Kishore, Rao, Nam, Rajagopalan and Chaudhury 2003).

Outsourcing can be done domestically or internationally. When the function is done in another country it is typically called off-shoring. According to Culpepper (2006), India and China currently receive the majority of off-shoring work from the United States.

Co-sourcing is another model that has gained popularity in the past few years. Co-sourcing is when Information Technology work is contracted for a specific project and for a specific time period. Co-sourcing companies work in the contracting company's facility. Companies that do co-sourcing usually have incentive clauses that if they beat agreed upon metrics that they earn bonuses. Co-sourcer's bring a large amount of experience and rigor to a project and therefore have the requirement of passing along their expertise to the contracting company so they can carry on the work after the co-sourcer leaves. Companies hire a co-sourcing company for projects that usually last no more than a few months to a year. However, there is no hard and fast rule.

Consultants could be considered outsourcers. They are contracted to perform work on a project or on a time period basis. There are usually no incentive programs and could be terminated with little or no notice. The work is completed onsite versus offsite like a traditional outsourcer. But given today's remote access tools, consultants can and do frequently work remotely.

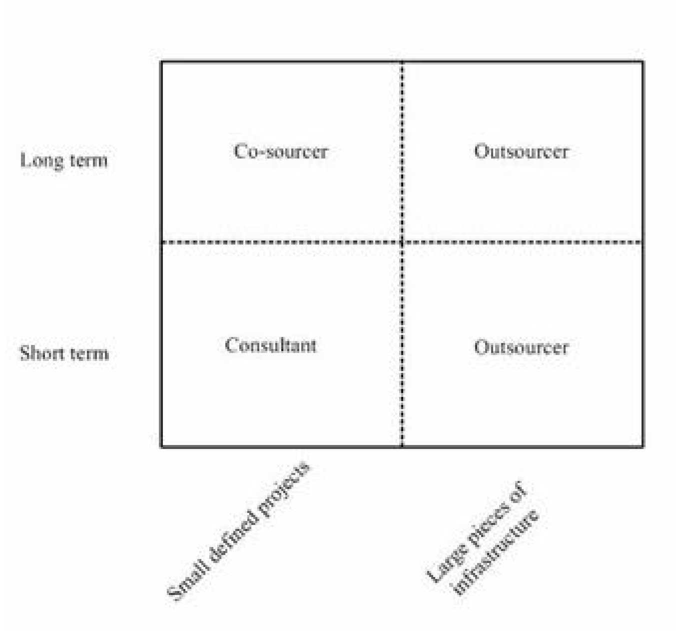

Figure 1. Outsourcing decision points

WHY DOES A COMPANY OUTSOURCE?

Previously we defined outsourcing as the contracting out or selling of an organizations software assets, people and activities to a third party supplier. But why do companies outsource? Companies outsource to save costs, focus on their core business, find their current service inefficient, and to increase quality (Laplante, Costello, Singh, Bindiganavile and Landon 2004).

Costs are still the main driver, but faster time to market and an accelerated delivery due to the ability to work around the clock play an important role (Yalaho, Nahar, Kakola and Wu 2005). Off shore outsourcers have the ability to expand development as needed. India graduates 82,000 engineers a year as compared to the U.S which graduates only 60,000 per year (Atlas, 2005). When doing business offshore, sometimes it is better to hire an outsourcer in that country that is located closer to the customer.

Advantages and disadvantages to outsourcing

Each company has to evaluate the advantages and disadvantages of outsourcing and then whether to send the work offshore or not. The following are a few risks associated with outsourcing (Aron, Clemons and Reddi 2005):

Operational risks due to cultural gaps (if off shoring)
Skill atrophy – a company loses its in-house ability to perform the function from outsourcing
Location risk – political and geographical in nature

However, there are advantages to outsourcing (Ferguson, McCracken, Kussmaul and Robbert 2004):

- Reduced cost
- Flexible staffing model
- Access to specialized skills
- 7x24 development access

Each company needs to balance the advantages with disadvantages. The flowing is a list of disadvantages a company might face: (Friedland, Longoria, Henry, Innes, Hom and Anderson 2005):

Cost prohibitive to small companies
Some work like Human Factors Engineering is best done with the key individuals who provide the input to the design

Time zone differences (if off shoring)
Communications difficulties (if off shoring)

Functions a company should keep in-house

Companies should not focus on the cost benefits alone as the decision point to outsource or not. Sometimes what makes sense financially does not make sense from an overall business strategy. For example, companies should not outsource strategic or any core competencies of the business even though it might make sense financially.

Key positions that should not be outsourced are any that affect strategic decision making, key product development or intellectual property related issues. These positions might include: Chief Software Architect, Software Architect, Information Architect, Database Architect

Positions that could be outsourced include: Data Center Operations, Help Desk Support, Desktop Support, and Application Programming

How outsourcers extend their contracts

- Uses their onsite people to look for opportunities
- Makes offerings – creates opportunities
- Agrees to extend the contract at a lower rate
- Tries to sign additional deals that extend past the original contract
- Agrees to do work for free to extend the contract

What to include and exclude from the contract

From the company doing the outsourcing perspective, the contract should include at least the following clauses:

- Incentive clauses
- Metrics
- Termination clause
- Buyout clause

Incentive clauses offer financial benefits to the outsourcer if they beat any agreed upon metrics. For example, a company specifies a server to be up and running 99.9% of the time. The contract with the outsourcer states that for every month that they beat that metric they are compensated $1500. This gives the outsourcer a financial incentive to do better and increase their revenue stream. The outsourcing company benefits by having a better server uptime and hopefully increased customer satisfaction.

Metrics are at the heart of every outsourcing contract. This is how an outsourcer is measured and compensated. The outsourcing company should put key metrics into the contract. These should be reasonable though. The goal should not be to make the outsourcer fail. These metrics should include:

- Server metrics
- Network metrics
- Application metrics
- Call center metrics
- Hardware repair metrics

A termination clause should be included to protect the outsourced company. Outsourcing companies do not like to include termination clauses. Companies include termination clauses for numerous reasons:

The outsourcer is not meeting metrics
Business turns critical and the company wants to protect its intellectual property

Company is bought by another company and they want to bring the work back in-house

Only the first point is a valid point to break a contract with an outsourcer. Typically, the outsourcer will have to miss meeting metrics for a few months in order to terminate the contract. Even then it is difficult to cancel the contract. Some companies do not know or understand the legal issues relating to outsourcing. In the average outsourcing contract, a customer will spend an additional 15% of the contract value in legal litigation costs (Goodridge, as cited by Goles and Chin 2005).

The buyout clause is the last option that many companies use to terminate a contract with their outsourcer. This clause simply states a graduated scale based on the remaining years left on the contract and what the outsourcing company must pay to terminate it. Many outsourcers try to include stiff fines for early termination. This may be open to negotiation.

Outsourcers like to have additional clauses added to the contract and companies should be aware of them:

- Right of first refusal
- Mergers and acquisitions
- Automatic extension

Right of first refusal gives the outsourcer the right to review and bid on any additional work not covered in the contract.

If the outsourcing company acquires another company, many contracts stipulate that the outsourcer automatically picks up the same services for the acquired company.

When nearing the end of an outsourcing contract, many companies take their time and negotiate a new contract with their outsourcer. If a new contract can not be reached by the time the contract expires, outsourcers put in an extension clause that extends the contract until a new contract is signed or cancelled.

Outsourcing companies would prefer to charge on a per head basis. That is they calculate how many fulltime employees (FTE's) it takes to support a project and multiply that number by a per hour basis. Projects should be negotiated on a per project or per service basis. This puts the burden back on the outsourcer to supply as many FTE's that are needed to support the project.

CONCLUSION

There are many good reasons to outsource, cost savings, flexibility, and a 7x24 support capability just to name a few. Each company has to evaluate the reasons on a per case basis. This paper attempted to bring to light some of the finer points to discuss when thinking about outsourcing development or support efforts.

CASE STUDY

This case study covers the Electronic Data Systems and GMAC Mortgage outsourcing strategy. This information was collected in February, 2006 from an interview with Salvatore Serago, an application manager and 26 year veteran with EDS.

A BRIEF HISTORY OF EDS

In 1962, Ross Perot founded Electronic Data Systems (EDS) selling unused time on mainframe computers. In 1984, General Motors (GM) agreed to purchase EDS for 2.5 billion dollars leveraging the company to supply its technology needs as well as allowing it to continuing to sell new outsourcing contracts. In 1996, EDS became an independent company again. Since then, the company has grown into a multi-billion dollar Information Technology outsourcer.

THE MASTER SERVICE AGREEMENT (MSA)

In 1996 when EDS became an independent company, GM signed a 10 year service contract with the newly formed company. This agreement, termed the Master Service Agreement or MSA, covered the products and services that EDS would supply to the auto-maker giant. The MSA covered GM and all of its subsidiaries including GMAC Mortgage, GMAC Insurance Group, and GMAC Commercial Finance Group all which fall under the General Motors Acceptance Corporation (GMAC) umbrella.

Additional services

After GM signed the MSA with EDS, it became apparent that there might be other services that they or their subsidiaries would need. GM allowed each subsidiary to sign agreements with EDS that went over and above the services covered in the original MSA. In the case of GMAC Mortgage, this included services such as System Security, Customer Relationship Management software, data warehousing, and Enterprise Systems Management.

Outsourced positions

An outsourcing agreement usually requires that the employees of the outsourced company be made offers to become employees of the outsourcing company. In this case study, GMAC Mortgage employees were made offers to become employees of EDS. Nearly 95% of GMAC Mortgage employees who were made job offers did become EDS employees. These outsourced positions included: Infrastructure Architecture, Unix Engineering, NT Engineering, Network Engineering, Desktop support, Helpdesk support, Application Architecture, Application Programming, Database Architecture, Database Engineering.

Outsourced services

Since EDS employees were on sight and had a strong knowledge of GMAC's operations, it became easy to see where opportunities existed for EDS to propose additional services. EDS would pair technical resources with the sales team to propose value-add products and services. Proposed services included: Enterprise Systems Monitoring, Helpdesk incident tracking software, Hardware and software upgrades, Application enhancements, WEB applications, Portal technology.

THE CONTRACT GREW

Between 1994 and 2001, the outsourcing contract between EDS and GMAC Mortgage grew from 2 million dollars annually to over 26 million in 2001. The GMAC Mortgage management team did not do a good job at managing EDS and found it easier to just outsource services rather than deal with the issue in-house or look for other competitors to outsource the work to. This allowed EDS to gain a strategic foot hold at GMAC Mortgage. The additional contracts that GMAC Mortgage signed were on a per head basis. This meant that they would be paying a premium for any additional EDS employee that was working directly on the account. EDS charged between $80-120 per full time employee (FTE) when working on a per head basis.

In 2000, the mortgage company learned that they could negotiate on a per service basis leaving EDS to supply as many employees as needed to provide the service. This would reduce the cost and put the risk in EDS's hands. Additionally, the mortgage company allowed EDS to negotiate hardware and software contracts and services on their behalf. EDS would create alliances with hardware and software companies and negotiate products at reduced rates. Often EDS would purchase the products and resell them at a considerable profit back to the mortgage company. EDS would typically markup hardware and software between 20%-50%.

Strategic insight

Since most of the EDS employees were previous GMAC employees, they were very intimate with the majority of the systems. Tensions grew over GMAC's first mortgage system. This system was used by all field offices to analyze and grant mortgages to home buyers looking for first mortgages. GMAC purchased this system from a small independent software company then turned it over to EDS to support it. The tension grew out of the concern that EDS was not providing enough capacity for the fledgling system. Despite EDS's unanswered insistence on business growth estimates and a proposal to redesign the system, the two companies could not agree on a strategy. The system continued to operate at a diminished capacity and cost the company revenue due to system unavailability.

The bubble burst

By 2000, the mortgage company realized that the relationship with EDS was failing and other software, hardware, and service providers such as Hewlett Packard, CompuCom, and EMC Corporation could provide the same service, in some cases better service, than EDS could. With outsourcing costs skyrocketing, this prompted the mortgage company to search for a way out of the federated agreements that they signed over the past years.

In 2001, GMAC decided to take back the contract. They employed the following strategy:

- Put all new projects on hold
- Did not renew any contracts for additional work EDS was performing
- Hired people to replace EDS employees
- Purchased their own equipment to replace what EDS bought over the years
- Discussed renewal of the MSA with EDS in 2006 to exclude GMAC Mortgage
- Diversified their contract work with existing vendors

- Hired back key EDS personnel

The transition back

In an effort to distance themselves from EDS, GMAC Mortgage opened a new datacenter in Texas and began hiring mortgage company employees to manage the servers. Knowing that the mortgage company was not going to renew its contract, prompted EDS to begin laying off employees and keep a minimal staff. The employees that did remain were offered positions with GMAC to help with the migration to the Texas facility. After the migration, these employees would be offered fulltime positions with GAMC Mortgage.

LESSONS LEARNED

The lessons learned were hard for most of the EDS employees. Both companies should have positioned themselves in a partnership role than in an adversary position. Neither company gained in revenue or business advantage.

Mortgage Company - lessons learned:

The mortgage company should not have continued to award EDS additional contracts without looking at other outsourcers. Key positions such as Infrastructure, Database, and Application Architecture never should have been outsourced. The mortgage company should have negotiated the additional work on a per service basis rather than a per head basis. The contract between GMAC Mortgage and EDS should have stipulated a reducing cost clause. Once EDS failed to provide support for the key application that generated first mortgages, it should have been turned over to another company for operational support.

EDS - lessons learned:

EDS should have used their influence as a market leader to provide additional discounts to GMAC Mortgage regarding software and hardware purchases. EDS should have leveraged their expertise in process improvement and operational initiatives such as CMMI and Enterprise System Monitoring and offered them as a free incentive to GMAC Mortgage to gain more business. EDS should have taken the lead on the migration to the Texas facility. This would have given them a foot in the door to supply engineers to manage the infrastructure after the migration.

CASE STUDY CONCLUSIONS

Outsourcing is not right for every company. In the EDS/GMAC Mortgage example, both companies lost. EDS lost an account, people, revenue and a piece of its reputation. GMAC Mortgage lost control of their strategic systems and people as well as revenue. Companies looking to outsource should put careful thought into why they want to outsource and then outsource only what they need to and keep strategic positions in-house.

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