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**THE AUSTRALIAN FEDERAL GOVERNMENT'S
CLUSTERED-AGENCY IT OUTSOURCING EXPERIMENT**

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**CASE STUDY:
OUTSOURCING**

THE AUSTRALIAN FEDERAL GOVERNMENT'S CLUSTERED-AGENCY IT OUTSOURCING EXPERIMENT

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ABSTRACT

Two detailed public reports on the Australian Federal Government's Clustered-Agency Information Technology Outsourcing Initiative were published recently. By analyzing these reports and drawing on additional material from various websites, it was possible to piece together four important lessons from the Australian Government's A\$1.2 billion 1997-2000 IT outsourcing experience. The lessons are: First, because of increased coordination costs, attempting to group a number of disparate departments to achieve economies of scale in single omnibus contracts does not work. Second, if massive change projects are to succeed, senior management must be committed to the project, and the needs and aspirations of all employees need to be handled fairly and sensitively. Third, making the transition to outsourcing is hard. Even with all the expert advice at its disposal, the Australian Government's IT outsourcing Initiative experienced enormous difficulties in transitioning to external service provision. Finally, cost savings are hard to achieve and surprisingly hard to measure. Many of these lessons were learnt before and are well documented in the literature. That they had to be re-learnt by these new players is itself an important lesson.

Keywords: information technology outsourcing, success guidelines, Australia, clustered-department it outsourcing, total outsourcing

I. INTRODUCTION

The study of what makes Information technology (IT) outsourcing successful is one of the most important topics in IT management today. A recent survey of IT Outsourcing practices in Australia [Cullen et al. 2001, Seddon et al. 2001] reports that 97% of 235 large Australian organizations were outsourcing at least some of their IT service provision. On average, those organizations were spending almost 30% of their IT budgets on outsourcing. Worldwide, Lacity and Willcocks [2001] suggest that total IT outsourcing expenditure is now in excess of US\$100 billion per annum, and rising. It is these huge expenditures on outsourcing that make it so important to understand which practices work and which do not.

In the last decade, much has been learnt about the factors that affect success with IT outsourcing. After the early reports enthusing about the benefits of IT outsourcing at Kodak [Applegate and Montealegre 1991], General Dynamics [Seeger and McFarlan 1993], and Xerox [Davis and Applegate 1995], researchers such as Lacity [1992], Lacity and Hirschheim [1993, 1995], Huber [1993], Willcocks and Fitzgerald [1994], and McFarlan and Nolan [1995] began in-depth studies of which practices work and which do not. In addition, by 1995, when Strassman [1995] published his damning conclusion that IT outsourcing was “a game for losers”, it was clear that outsourcing was a complex approach to IT service provision that required careful management from both client and vendor organizations, and did not always deliver the expected benefits. By 1997, Willcocks and Lacity [1998] were able to assemble a set of papers, most written in 1995-96, from fourteen groups of researchers who had all contributed to our understanding of what worked and what did not. Willcocks and Lacity note in their introduction [pp.12-13] that the IT outsourcing market at that time was still relatively immature, and that many client organizations lacked sufficient experience to work effectively with IT outsourcing vendors.

In the latter part of the decade the causes of success and failure became clearer as further research was published [Ang and Straub 1998, Feeny and Willcocks 1998, Hu et al. 1997, and Lacity and Willcocks 1998], so that by the year 2000, Lacity and Willcocks [2001] were able to offer a list of “proven practices” for IT outsourcing success. Their “proven practices”, drawn from their detailed analysis of 116 large IT “sourcing decisions” over the previous decade include the following [p.xiii]:

- (1) the use of a selective sourcing strategy rather than all-or-none outsourcing strategies,
- (2) identifying core IT capabilities to keep in-house (see the nine “core capabilities” for successful IT management in Feeny and Willcocks [1998] and Chapter 7 in Lacity and Willcocks [2001]),
- (3) identifying non-core IT capabilities for potential outsourcing,
- (4) conducting a rigorous evaluation of market options and supplier offerings,
- (5) clearly defining IT outsourcing expectations and mitigating risk in a contract, and
- (6) implementing post-contract management processes and structures to enable supplier success.

In addition to endorsing the relatively greater success of selective over total outsourcing¹, Sambamurthy et al. [2001, p.299] suggest that IT outsourcing is also more likely to be successful if it is focused on activities where external providers:

- (7) supply expertise that is currently lacking,
- (8) can capitalize on economies of scale, and/or
- (9) take on responsibilities not considered critical to the customer organization.

Finally, Cullen [1997] argues strongly for:

¹ Lacity and Willcocks [2001, p.4] define “total outsourcing” as at least 80% of an organization’s IT budget.

(10) the use of regularly-renegotiated service level agreements (e.g., monthly) as the basis for sound ongoing management of IT outsourcing relationships.

These “ten commandments” constitute some of the world’s best available advice or theory about how to achieve successful outcomes from IT outsourcing.

Seemingly flying in the face of these ten commandments, in January 2001 the Australian Federal Government completed what can best be described as a bold four-year field experiment in total IT outsourcing. The innovation in the experiment involved grouping government agencies (mainly departments) into clusters and mandating that they outsource all their IT services. The experiment directly affected thousands of peoples’ jobs, and left the Australian government with five five-year IT Outsourcing contracts worth a total of A\$1.2 billion (approx. US\$600 million) that will affect government IT service provision for many years to come.

The experiment began on 25 April 1997 when the then Minister for Finance, John Fahey, announced the Government’s *“in-principle approval to outsource its Information Technology (IT) infrastructure”*. It ended almost four years later, on 12 January 2001, when the now Minister for Finance and Administration, John Fahey, announced that he had accepted the recommendation of Independent Reviewer, Richard Humphry, that:

“agencies should proceed to outsource their IT infrastructure within the overall government policy to outsource, but should exercise their own discretion on what should be outsourced and the manner in which that outsourcing should take place.”

It is the second half of the above quotation that matters. By allowing heads of government agencies to exercise their own discretion about what should be outsourced, the Minister was in effect terminating the experiment. Because of the difficulties government agencies and departments experienced with

clustered-agency total IT outsourcing, it seems safe to predict that many of the remaining Heads of agencies will now chose *not* to outsource all IT service provision, if they outsource at all.

A lot of heat and anguish was generated by the events described in this paper. The purpose of this paper is therefore to describe the experiment as accurately, fairly, and unemotionally as possible, relying only on documented facts to draw four important lessons. The lessons are as follows:

- 1. Don't cluster.** The apparent economies of scale that can be gained by grouping agencies into clusters are overwhelmed by the increased coordination costs required to manage the clusters. This lesson is particularly true for total outsourcing, which involves a myriad of IT services.
- 2. Gaining commitment of all participants is essential.** If massive change projects are to succeed, senior management must be committed to the project, and the needs and aspirations of all employees need to be handled fairly and sensitively. Minister Fahey's 1997 media statement says

“A significant majority of the 2800 employees currently working in mainframe, mid-range and desktop areas will be able to enhance their career opportunities by transferring to the private sector suppliers.”

Transfer rates of 70-80% of employees were expected. In practice, transfer rates for the three clusters reviewed in this paper were more like 30-40%. Many employees took their severance pay and either found other jobs or retired. This low transfer rate resulted in enormous loss of organizational knowledge, particularly of legacy systems.

- 3. Making the transition to total outsourcing is hard.** *“The experience of Cluster 3 and Group 5 highlighted that both agencies*

and tenderers underestimated the complexity involved in simultaneously transitioning to an outsourced provider the delivery of IT infrastructure services to a number of agencies.” [ANAO 2000, para 8.5]

- 4. Cost savings through outsourcing are surprisingly hard to measure and may be unattainable.** Although the 1997-98 federal budget talks of cost savings of \$100M p.a., representing 15% of the government’s total IT expenditure, cost savings are actually very hard to achieve. It seems likely that three out of four tenders discussed in this paper will not achieve cost savings.

The above lessons were learnt at considerable cost. If the government had known in 1997 what it knows now, it is fair to say that it would have not have embarked on the experiment described in this paper.

II. THE WHOLE-OF-GOVERNMENT IT OUTSOURCING INITIATIVE

Consistent with its strongly-held ideological belief that privatization is good, and with the example of numerous other governments’ IT outsourcing initiatives around the world², the Australian Federal Government’s IT Outsourcing Initiative began with the laudable objectives of saving costs, improving service, and enhancing industry development throughout Australia³. One year after taking office from the previous federal Labor government⁴, Minister Fahey’s 25 April 1997 media release captures the essence of the plan:

² The 27-page February 1998 edition of the US-government-backed OIS Newsletter (Ronen and Mathews 1998) provides a contemporary glimpse of worldwide English-speaking government views on IT outsourcing in late 1997. Available online at <http://policyworks.gov/intergov/ois.newsletter.feb.pdf>, it contains sixteen one-to-two-page articles about government IT outsourcing projects in the US, UK, Canada, Singapore and Australia. OMB Circular A-76 (Office of the [US] President 1983) mentioned in a number of the US-authored articles is available at <http://www.whitehouse.gov/omb/circulars/a076.pdf>

³ A full list of objectives is presented in the Office of Asset Sales and IT Outsourcing (OASITO) Annual Report 1998/99 (1999, pp.30-31). It also appears in the above-mentioned OIS Newsletter, page 4.

⁴ The privatization-minded Howard Government was elected into office on 4 March, 1996.

“This initiative will build on the experiences of other governments and private sector organisations, here and internationally, who have already successfully outsourced.

“The Government is committed to achieving the best value for its information technology dollar, to support the delivery of services at the lowest cost to the taxpayer.

“This initiative creates substantial opportunities for small to medium-sized Australian enterprises. Partnering arrangements with vendors will be encouraged. This will enhance the international competitiveness of local companies through the opportunities created to work with leading edge outsourcers. Small to medium enterprises are also expected to fulfil a significant role in the provision of regional support services which will still be required under outsourcing, particularly for desktop services”

To gain full advantages from economies of scale, a number of large and small government agencies (e.g., two large and four small departments) were to be formed into clusters that were to purchase all their IT services from a single prime contractor. A total of eleven clusters or groups were to be formed. The initial plan was that all eleven contracts would be in place by June 1999 [ANAO 2000 para 16]. According to the 1997-98 budget [Costello, May 1997], the plan was expected to save A\$100 million per annum, or 15% of the government's 1997 annual IT expenditure, from the year 2000⁵.

Three and a half years and an enormous amount of effort later, by December 2000, five of the eleven Group contracts had been let, one tender had been

⁵ In anticipation of cost savings, reductions were made to the forward estimates of IT expenses for Budget-funded agencies in the 1997-98 Budget. “The reductions totalled \$37.9 million in 1998-

withdrawn due to failure to attract a bid offering sufficient cost savings (DEETYA&CN), two more current tenders were due to be finalized in 2001, and the remainder were in the pipeline. Details of the contracts let and tenders under consideration at the end of 2000 are summarized in Table 1. As shown in the bottom row of Table 1, the total value of the five five-year contracts already let was A\$1,221 million. Total expected cost savings over the lives of the contracts were A\$264 million [Humphry 2000, Appendix 2].

Table 1. Status of the Groups under the IT Outsourcing Initiative, December 2000

Group/Cluster	Agencies	Status	Contractor (duration)	Contract Value \$m	Savings Estimate *\$m	No. of Desktops	Scope of IT Infrastructure	Nature of contract
Completed Contracts								
2	3 large Health agencies	Completed contract signed 6 Dec.1999. Handover of services at various dates.	IBM GSA (5 years)	\$ 351	\$ 54	8,000	Mainframe of 1,300 MIPS, Midrange, desktop, data comms and cross platform services	Three separate contracts
3	7 (3 large 4 small)	Completed contract signed 31 March 1998. Handover of services on 1 July 1998	CSC Aust. Pty Ltd (IT: 5 years; Data: 2 yrs)	\$ 160	\$ 60	5,200	Mainframe, midrange, desktop, and voice services over a five year period	Single 5-year contract
4	1 (Aust Tax Office)	Completed contract signed 31 March 1999. Handover of services on 23 June 1999	EDS Australia (IT: 5 years Carriage:2yrs)	\$ 490	\$ 100	18,000	Mainframe of 900 MIPS, Midrange, desktop, data & voice comms, cross platform services	Single 5-year contract
5	5	Completed contract signed on 14 April 1999. Handover of services on 1 July 1999	Advantra Pty Ltd. (5 years)	\$ 90	\$ 10	4,000	No Mainframe, included Midrange, desktop, data comms, and other services	Single 5-year contract
8	7	Completed contract signed on 9 March 2000. Handover of services on 26 June 2000	Ipex ITG (5 years)	\$ 130	\$ 40	7,500	No Mainframe, included Midrange, desktop, data & voice comms, 100 research systems	Single 5-year contract
Discontinued Tenders								
?	2 (DEETYA & CN)	Discontinued 11 June 1998 in the absence of competitive tenders.						
Current Tenders								
1	2	Currently in the market place. Tenders closed Dec '99. Evaluation underway	-	-	-	30,000	Mainframe of 5,000 MIPS. Midrange, desktop, data comms and cross platform services.	Anticipated separate contracts
11	5	RFT released September '00 – Tenders close 31 January 2001	-	-	-	8,000	Mainframe of 1,100 MIPS, Midrange, desktop, data and voice comms and other services	
A\$ Total				\$ 1,221	\$ 264			

(Sources: Humphry Report [2000], Appendix 2, pp.45-49; ANAO [2000], Figure 1.2, p.45.)

99, \$87 million in 1999-00, and on-going annual reductions in agency budgets of \$99.2 million from 2000-01.” (ANAO 2000 para 5).

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Because all participants in the contracting process are bound by confidentiality agreements, very little public information was available until recently to enable detailed independent assessment of the value of the Whole-of-Government IT Outsourcing Initiative. However, in September 2000, the Australian National Audit Office (ANAO) published a detailed 243-page performance evaluation of the effectiveness of the Initiative [ANAO 2000]. In a highly political environment, this carefully-written report, which is available on the web, is the primary source of detailed information for this paper. Prepared at a cost of A\$535,000 [ANAO 2000, paragraph 1.25, page 49], the Auditor-General's report focuses on the effectiveness of the Group 3, 4, and 5 contracts. It provides a rich source of data for understanding the evaluation, implementation, and outcomes-to-date of these three contracts. In addition, the report contains comments from the three Contract Management Offices responsible for the Group 3, 4, and 5 contracts, the Office for Asset Sales and IT Outsourcing (OASITO) -- the agency responsible for managing the overall Initiative -- and a number of external service providers. These comments help the reader form a balanced assessment of the success of the government's IT Outsourcing Initiative.

Towards the end of the year 2000, internal reports, tabling of the above ANAO report in Parliament, and rumblings of protest from the community⁶ evidently raised enough concerns to prompt Minister Fahey to commission an Independent Review of the government's IT Outsourcing Initiative. The person he chose to head the Review was Richard Humphry. Humphry was a significant choice, since he had been a member of the 1997 Information Technology and Telecommunication Policy Advisory Committee that had recommended the IT Outsourcing Initiative to the government in the first place [Humphry 2000, p.22]. Terms of reference for the Independent Review were published on 14 November, 2000. The report was due in six weeks. On 12 January, 2001, the 108-page

⁶ Awkward questions were being asked in parliament by the opposition spokesperson on outsourcing, Kate Lundy. In addition, employees of the government scientific research organization, CSIRO, a member of Group 9, organized a number of public demonstrations in the streets of Sydney as part of their attempts to prevent outsourcing of their IT.

Humphrey Report [2000] was released. That report, which is also available on the web, is the second key source of detailed information for this paper.

In essence, the Humphry report recommended that the government's mandated clustered-agency, whole-of-government IT Outsourcing approach should be terminated. In its place, he recommended that rights for deciding what gets outsourced, if anything, should be devolved to heads of departments and other agencies. With regard to tenders (not contracts) already underway (i.e., Groups 1, 11, 9, and 10), Humphrey recommended that control and direction of evaluations of those tenders should pass immediately from OASITO to the heads of the affected departments⁷. These recommendations were the result of a courageous and radical shift in his thinking. Explaining why he shifted from his 1997 position, Humphry [2000, p.6] says he has learnt that:

"IT outsourcing is at its heart about the management of human resources and cultural change, of which technology is an important but not dominant element."

In releasing the Humphry Report, Minister Fahey said he had accepted all ten of Humphry's recommendations [Fahey 2001]. His announcement marked the end of the Australian Federal Government's Clustered-agency IT Outsourcing Experiment. The government's new policy now allows Heads of agencies to follow the ten commandments presented in the Introduction should they so choose.

⁷ Humphry is silent about Groups other than 1, 11, 9, and 10, but it seems safe to assume that the remaining groups will be given similar options.

III. LESSONS LEARNT ABOUT CLUSTERED-AGENCY IT OUTSOURCING

LESSON 1: DON'T CLUSTER.

The idea for clustering seems to have come from the outsourcing vendors in the mid-1990s. A 1995 report by the Minister for Finance's Information Technology Review Group [1995] notes that IBM recommended that the government should consolidate data centers to achieve cost savings.

“IBM Limited had estimated savings from increased outsourcing of government information technology services to be in the range of \$1 billion over the subsequent five or six years, based on a net benefit of 20 percent.”

“although a number of Commonwealth agencies were already at, or close to, an economic size in terms of data centres, there were a number of smaller sites which could be consolidated. The report recommended that the consolidation of infrastructure be considered by aggregating like agencies on the basis of business type.” [ANAO 2000, para 2.27]

Whilst consolidation of data centers may result in economies of scale, and therefore make sense, it does not follow that consolidation of all IT service provision makes sense. However, in late 1995 the South Australian government had outsourced *all* its IT service provision to a single vendor [EDS 2000], and that, combined with the germ of the idea planted by IBM, the newly-elected government's ideological commitment to privatization, and the many IT outsourcing success stories circulating around the world at that time, seems to have guided the thinking of the key decision makers. In any event, by 1997 the Department of Finance's IT Advisory Committee was recommending a clustered-

agency approach to IT outsourcing not just for data centers, but for *all* IT services:

“responses from vendors had indicated that the outsourcing of IT services in multi-agency clusters would result in significant financial savings compared with separate outsourcing activities by individual agencies.”
[ANAO 2000 para 2.28]

Clustering was expected to produce significant benefits including:

“financial savings in ESP [external service provider] charges; reduced tender costs to Government and industry; increased opportunities for rationalisation and standardisation between agencies; and efficiency in contract management.” [ANAO 2000, para 3].

However, experience now shows that any economies of scale attainable through clustering were more than offset by the increased coordination costs required to manage heterogeneous IT service provision through clusters⁸. Repeatedly throughout the Auditor-General’s report there are references to difficulties encountered as a result of the decision to outsource IT via clusters of agencies. The following quotation from the Auditor-General summarizes the issues⁹:

“8.4 An issue which has been highlighted by the experience gained to date is the significant additional complexity involved for both parties in managing the delivery of services to a group of agencies.¹⁷⁹ The multi-agency groups, Cluster 3 and Group 5, have experienced, to varying degrees, considerably

⁸ If they were not *more than* offset, the experiment would not have been abandoned.

⁹ In the quotation, “ATO” refers to the Australian Tax Office, the single department that constitutes Group 4. The ESP for the ATO is EDS Australia. The sentence in bold is emphasized in the original. Footnote 179 referenced in the quotation says: “In June 1999, IP Australia reported that clustering in an IT outsourcing initiative had proved to be more complex and difficult for both the ESP and Cluster members than had been imagined.”

more disruption to service delivery than has the single agency group, ATO, with significant shortfalls in the provision of contracted service levels during the first year of the Agreements. The ATO ESP advised ANAO in August 2000 that: 'It [has] been our general experience that working with single agency groups has been more effective and presented less difficulties at all stages of the procurement.'

"8.5 The experience of Cluster 3 and Group 5 highlighted that both agencies and tenderers underestimated the complexity involved in simultaneously transitioning to an outsourced provider the delivery of IT infrastructure services to a number of agencies."[ANAO 2000, paras 8.4 and 8.5]

In short, the attempt to gain economies of scale by clustering government agencies seems to have caused coordination costs to rise so much that service levels fell, and overall IT service-provision costs rose, not fell. For the future, agencies within existing multi-agency single contracts (Groups 3, 5, and 8) will have to work within or renegotiate those contracts. But for those agencies not yet committed to contracts, Humphry's recommendations (that agency heads should exercise their own discretion on what should be outsourced and the manner in which that outsourcing takes place) probably mean that clustering is over. It is risky to generalize from just two contracts (Cluster 3 and Group 5), but it seems likely that the Australian experiment discovered an important caveat for the "outsource when you can gain economies of scale" commandment (commandment 8 in the Introduction): clustering disparate user organizations to achieve economies of scale in total IT service provision does not work. Clustering may work for simple services, such as electrical power, shared services, or accounts payable, but not for such complex services as whole-of-agency IT.

LESSON 2: GAINING COMMITMENT OF ALL PARTICIPANTS IS ESSENTIAL

The key lesson that Independent reviewer Humphry seems to have learnt from the four-year Initiative is that it is imperative to gain commitment from the majority of the people involved:

“Fundamental to an understanding of transition is that it is not merely a technology issue. The implementation project at its heart is about the management of human resources and cultural change, of which technology is an important but not dominant element.” [Humphry 2000, p.11]

Commitment matters in at least two ways. First, the government failed to achieve commitment to the project from senior management in its various agencies. Second, the government’s decision to outsource IT created a host of human resources (HR) problems for the agencies’ IT staff, the agencies themselves, and the vendors. Both factors appear to have been equally important.

With respect to senior management’s lack of enthusiasm for the Initiative, the government’s solution was to impose outsourcing on them from above through the Office for Asset Sales and IT Outsourcing (OASITO). To reinforce the message, in December 1998, eighteen months into the Initiative, Prime Minister, John Howard, issued the following edict:

“as a general Government policy, outsourcing of IT infrastructure services should proceed unless there is a compelling business case on a whole-of-Government basis for not doing so”. [Australian National Audit Office (ANAO) 2000, paragraph 8]

But pressure from above did not make senior management any more willing to cooperate. As Humphry [2000] reports:

“There has been a general lack of buy-in by senior management and an unwillingness to accept that the Initiative is the most appropriate approach to IT outsourcing. This lack of buy-in is by far the most significant risk factor for implementation management. The lack of acceptance by agencies has presented the Initiative with difficulties at every stage. [Humphry 2000, p.11]

With respect to human resource (HR) issues, outsourcing created the usual set of problems for employees, vendors, and clients (the government agencies). From the individual employees' points of view, the whole experience was very unsettling. Did they want to work for the outsourcing vendor? Should they look for a job elsewhere? Were redundancy payments available? If so, when, and for how much? From the agencies' points of view, if employees chose not to accept positions with the vendor there was a distinct risk of loss of organizational knowledge that would make transition to the new arrangement difficult. But agency management also felt a duty of care to their staff that motivated them to offer large redundancy payments to their IT staff. From the vendors' points of view, managers were no doubt reluctant to hire “dead wood”, but equally they needed to hire sufficient staff to maintain and run the government's systems, particularly its legacy systems. If hired, how much should the new employees be paid? What were their leave entitlements, retirement benefits, etc.? These problems are not new, but the details of how the government and its advisors sought to solve them in this late-1990s outsourcing initiative provide some valuable lessons for potential future outsourcing initiatives by other organizations.

The government's decisions with regard to these HR issues are described in detail at the OASITO website [OASITO date unknown]. Basically, the government decided to give agencies the choice between what was called a Clean Break or a Phased approach to staff transition, with the proviso that all agencies in a cluster must adopt the same approach. Under the Clean Break approach, the entire cluster's IT employees were to be made redundant. This

entitled them to a severance payment of two weeks pay for each year of service, up to a maximum payment of 48 weeks (24 years of service). Employees could then choose to accept a job with the vendor, or not, as it suited them. Under the Phased approach, the successful tenderer was required to meet its additional staffing requirements initially from agency staff. In each of the three Groups studied by the Auditor-General, the Clean Break approach was adopted by the affected agencies. Factors influencing agencies' decisions included "precedents within the Commonwealth, existing industrial agreements within agencies and informal advice on staff preferences." [ANAO 2000 para 8.33]. Under this approach, government IT staff had the option of accepting voluntary redundancy or applying for redeployment to other jobs or agencies.

In the event, having been made redundant, many former Group 3, 4, and 5 agency employees took their severance pay and either found other jobs or retired¹⁰. Failure of Group 3, 4, and 5 IT staff to seek positions with vendors resulted in enormous loss of organizational knowledge:

"The number of existing agency staff that took up positions with the Cluster 3, ATO and Group 5 ESPs was considerably below that which agencies had considered desirable in order to maintain continuity and the transfer of knowledge of agency infrastructure. In most cases, the estimated level of transfer represented about one-third of in-scope positions. In the context of the risk assessment conducted as part of the tender process, ATO had said that it was important that at least 70 to 80 percent of staff transferred to the successful tenderer. In a number of agencies, the low levels of staff transfer contributed to operational difficulties following handover due to the loss of corporate knowledge and

¹⁰ By contrast, for the Health cluster, Group 2, "More than 80% of former in-scope staff members of the Health Group Agencies elected to accept positions offered by IBM GSA or its subcontractors." (OASITO 2000, p.24). It is not known why the take-up rate was different for this cluster.

technical skills, especially in the operation of legacy systems. [ANAO 2000 para 8.47]

These concerns about the impact of the government's staffing policy are endorsed by at least one service provider, in this case, CSC Australia. In an August 2000 comment on the proposed ANOA report, the Cluster 3 ESP says:

'The exercising of the Clean Break approach for existing staff by agencies is a further major issue in achievement of a timely, cost-effective, proper transition. Given the disparate nature of the business of agencies in Cluster 3, [it] does not understand the logic of all agencies having to exercise the same option and considers this to have had a detrimental effect upon both agencies and [itself].' [ANAO 2000 p.191, footnote 193]

Clearly, participant commitment was lacking in the government's IT Outsourcing Initiative. Senior agency management did not back the Initiative, which probably doomed it from the start. In addition, the government's high-handed approach to the Initiative appears to have caused many of its former IT employees to look for other employment or retire. This outcome resulted in a loss of organizational knowledge that must have caused great difficulties for the outsourcing vendors.

LESSON 3: MAKING THE TRANSITION TO TOTAL OUTSOURCING IS HARD.

As noted earlier, by 1997 the world knew a lot about IT outsourcing. To ensure success, the government paid top dollar for the best advice. It employed US law firm Shaw Pittman for strategic advice and contract negotiation¹¹. The government also chose to work with the world's most experienced outsourcing vendors (including IBM GSA, CSC, and EDS). Given all this access to high-powered knowledge and experience, the process of transitioning from internal to

¹¹ By 31 May 2000, Shaw Pittman had been paid a total of \$17M (60% of all consulting fees for the Initiative) for its advice. Individual partner-level fees to Shaw Pittman were extraordinarily high: US\$85,000 per month (ANAO 2000, paras 3.4 to 3.19, and footnote 44, p.53).

external service provision should have been expected to run reasonably smoothly.

Yet the transition was not smooth. The Auditor-General's report is replete with details of difficulties encountered by all three Groups in thrashing out contracts, defining service levels, measuring service levels, managing external service providers, providing appropriately-substantiated invoices, agreeing on credits for failure to meet agreed service levels, and resolving disagreements over disputed invoices. In some cases, service levels dropped significantly:

“In August 1999, the Group 5 Management Committee advised the ESP that the service difficulties represented a significant erosion over the services delivered in agencies prior to handover. Although acknowledging that the ESP was attempting to fix the problems, the Group wished to put on record that the service problems were having a real and significant impact on business in Group 5 agencies, and seriously affecting productivity.” [ANAO 2000 para 8.12]

In other cases, problems emerged with procedural matters such as invoicing and failure to deliver promised performance reviews. For example:

“As at June 2000, the ATO had yet to pay telecommunications invoices for the first year of the Agreement.” [ANAO 2000 para 8.53]

The Auditor-General sums up the extent of difficulties experienced by the agencies in moving to external service provision as follows (Cluster 3 is Group 3 and the ATO is Group 4):

“34. The initial contract management effort required in respect of the Cluster 3, ATO and Group 5 Agreements has exceeded the expectations of many agencies, with the increased management effort and transaction

costs occurring at both the operational and senior executive levels. Many of these latter costs resulted from the need for senior management to focus on the delivery of the relevant services to an extent not previously experienced in order to address initial service delivery problems. These transaction costs are not fully captured in the overall reported costs of managing the Agreements.

35. A stabilisation period can be expected following outsourcing, but it has taken longer than expected to obtain the anticipated level of cost and performance visibility and, in some areas, to achieve contracted levels of service. The experience of Cluster 3 and Group 5 highlighted that both agencies and tenderers underestimated the complexity involved in simultaneously transitioning to an outsourced provider the delivery of IT infrastructure services to a number of agencies.” [ANAO 2000, paragraphs 34 and 35]

Confirming these difficulties of transition, Cluster 3 vendor, CSC Australia, is reported as saying:

“[It] believes that the complexity and length of transition was seriously underestimated. This factor is a significant contributor to any perceived shortcomings in a strictly literal interpretation of performance and the Agreement. It is simply not practical for a central agency like OASITO to determine realistic and appropriate parameters for a disparate group of operating agencies. The sound understanding required by both sides cannot be externally determined and needs to remain a matter of flexibility and negotiation under operating circumstances.” [ANAO 2000, para 8.45]

Finally, Independent Reviewer Humphrey also comments on transition problems:

“There has been a lack of focus on the managerial and operational aspects of implementation by OASITO, for the sake of settling legal and contractual arrangements according to an ambitious timetable. Similarly, there have been concerns that some agencies lacked sufficient in-house expertise to manage transitional arrangements. The time taken for some contracts has been significantly longer than anticipated (Appendix 6). While the time taken for Request for Tender (RFT) and contract development has been extensive, the time taken to build essential ESP/agency relationships before entering into the contractual arrangements has been less than adequate. This has magnified the transition risks and multiplied the amount of management effort required by both customer and ESP to overcome transition and service delivery hurdles.” [Humphry 2000, p.11]

In short, making the transition from internal to external IT service provision is hard, particularly in total outsourcing deals such as these. Again, this is not a new lesson. Every organization that outsourced had to deal with transition problems. What is surprising is that even with access to so much expert advice on ways of handling the transition, both the government and vendor firms found these particular transitions so difficult. Some of the difficulties were clearly exacerbated by clustering and lack-of-commitment problems mentioned in Lessons 1 and 2 above, but the extent of difficulties was still much greater than anyone expected.

LESSON 4: COST SAVINGS THROUGH OUTSOURCING ARE SURPRISINGLY HARD TO MEASURE AND MAY BE UNATTAINABLE

One of the government’s primary objectives for IT Outsourcing Initiative was to save costs. Actually achieving cost savings proved to be harder than the government expected, and even knowing if they have been achieved or not is surprisingly difficult. It is rare to see audited details of cost savings discussed in public, which is why it is worth examining them now.

Estimated non-discounted¹² cost savings for the three contracts analyzed in the Auditor-General's report, i.e., for agency Groups 3, 4, and 5, are shown in Table 2. Baseline "estimated future costs from continued in-house operations" [OASITO 2000, page 21] are shown in row 1. OASITO estimates of cost savings *at the time the tender documents were accepted* are shown row 2. OASITO, of course, would have been under gentle political pressure to make these savings appear as high as possible. In particular, OASITA would have been conscious of the government's 1997 budget forecast of 15% cost savings [Costello 1997].

Table 2. Estimated Non-Discounted Anticipated Cost Savings from IT Outsourcing for Groups 3, 4 and 5 at the time of selection of preferred tenderer

		Group 3 1997-98	Group 4 1998-99	Group 5 1998-99	DEETYA & CN
1	Original five-year baseline cost	\$220M	\$590M	\$100M	Tender discontinued on 11 June 1998 due to absence of cost-competitive tenders.
2	OASITO's estimated cost savings <i>at time of selection of preferred tenderer</i>	\$60M	\$100M	\$10M	
3	Auditor-General's estimated cost savings <i>at time of selection of preferred tenderer</i>	\$61M	\$29M	-\$7M	
4	Auditor-General's cost savings as a percentage of the baseline costs	28%	5%	-7%	
5	Less OASITO tender evaluation costs	3%	3%	3%	
6	Final cost estimated savings to the Groups <i>at time of selection of preferred tenderer</i>	25%	2%	-10%	

Sources: ANAO [2000], paras. 6, 24, and Figure 1, page 19; Humphry [2000], Appendix 2; OASITO 1999]

Comparable estimates of cost savings from the more independent-minded Auditor-General are in row 3. OASITO and the Auditor-General disagree about how values of end-of-period assets should be treated, competitive-neutrality adjustments¹³, and on the use of discounting of future cash flows. Since contract

¹² Because the contracts run for five years, the ANAO report argues that costs should be discounted at 8%p.a.

¹³ Competitive-neutrality adjustments adjust reported savings to compensate for the fact that private outsourcing vendors are entitled to a return on capital and pay taxes that government departments do not pay. OASITO's estimate for Group 3 is before competitively-neutrality adjustments. Its estimates for Groups 4 and 5 are post competitively-neutrality adjustments. (Phone call to Auditor-General's office, 12 Feb 2001). OASITO's figures before competitive neutrality adjustment for Groups 4 and 5 would appear to have been \$60M and \$1M respectively (ANAO 2000, Figure 1). The position taken in this paper is that return on vendor capital is a real cost of outsourcing that should not be ignored in computing cost savings. So the Auditor-Communications of AIS, Volume 5 Article 13

values are normally reported in the press in terms of the total non-discounted payments over the lives of the contracts, only non-discounted figures are reported in Table 2.

The estimated cost savings in rows 2 and 3 do not reflect costs in agency senior management time for managing the transition or the costs incurred by OASITO in managing the tendering process. No data are available on senior management opportunity costs, but the costs incurred by OASITO appear to be about 3% of the value of contracts issued [ANAO 2000, para 19]. Using the Auditor-General's non-discounted figures and subtracting 3% for OASITO's costs, some crude estimates of expected cost savings at the times of contract approval are shown in row 6 of Table 2. Based on the figures in Table 2, the Group 3 contract looks like a winner, but Groups 4 and 5 are marginal propositions. Since the DEETYA¹⁴ tender was cancelled due to lack of competitive tenders, it appears that even at the time of tender evaluation, three of four tenders were not likely to produce significant cost savings. Evidently it is not as easy to achieve cost savings through IT outsourcing as the government had been led to believe.

Table 2 is all about *expected* cost savings. Once the contract is underway, conditions change and it becomes increasingly difficult to define, let alone measure, *realized* cost savings. As illustrated in the following comment from Group 3 service provider, CSC, if baseline service requirements have changed, it makes no sense at all to compare cost savings to the original tender document costs:

“Given the complex and diverse nature of the infrastructure inherited by [us], and the large differences in agency businesses, [we] consider that the progress in replacement of substandard infrastructure, additional capacity, network and facilities and the remediation work undertaken for

General's cost savings estimates before competitive-neutrality adjustments are reported in Table 2.

¹⁴ Department of Employment, Education, Training and Youth Affairs

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Y2K are significant achievements. Undertaking this work, in close consultation with Cluster 3 agencies to meet their business needs, had a higher priority than some other elements of the Agreement and were undertaken at substantial cost to [us].

“Unplanned activities ranging through a Federal Election, a Referendum and refugee and humanitarian relief exercises, also added to the volume and complexity of work. [We] believe it unrealistic to simply measure performance against a contract document written some time ago, rather than the living reality of its clients’ – and Government’s – dynamics.”
[ANAO 2000, para 8.26, p.187]

Despite the measurement difficulties, the Government had framed its decision to outsource in terms of cost savings, so the question will always be asked: “Did the contract result in cost savings?” At the time of publication of the Auditor-General’s report only one estimate of actual cost saving was available. The Cluster 3 contract management office (CMO), the cluster shown in Table 2 as the most likely to yield cost savings, had attempted to estimate cost savings for the first year of the Agreement, 1998-99 [ANAO 2000 paras 8.50-51]. Its estimates are discussed below. At the time of publication of the Auditor-General’s report Cluster 4 was still awaiting data for estimating its first-year cost savings, and Cluster 5 had decided that “the process of measuring cost savings is unreliable” and “will not assist (and may distort) appropriate decision-making by contract managers and government” [ANAO 2000 paras 8.53-54]. A cynic might wonder if Cluster 5 management had some inkling of an outcome the government might prefer not to have quantified.

With respect to the only available estimate of realized cost savings, the Auditor-General says:

“8.50 The Cluster 3 MC advised ANAO that, in its view, substantial outcomes had been achieved for the Commonwealth under the Cluster 3

Agreement at a cost which, on the available evidence, was consistent with the contract and lower than the internal costs the Commonwealth would have had to incur for similar services. The Cluster 3 CMO estimated the savings realised in the first year of its Agreement by comparing the service charges and direct contract management costs incurred with the agency cost baseline used in the tender evaluation, which it normalised to reflect the actual volumes consumed during 1998-99.

8.51 The Cluster 3 CMO identified savings of \$5.8 million, or 12 percent of the normalised agency baseline.¹⁹⁶ This was about 80 percent of the rate of first year savings forecast in the tender evaluation for the agencies considered in the Cluster 3 CMO's analysis. Relevant agencies were expected to accrue savings of 15 percent of the agency cost baseline (\$6.4 million) in the first year for the equivalent costs (see Figure 8.1).¹⁹⁷ Savings were identified for all but one agency, but at a generally lower rate than expected.¹⁹⁸ [ANAO 2000 paras 8.50 and 8.51]¹⁵

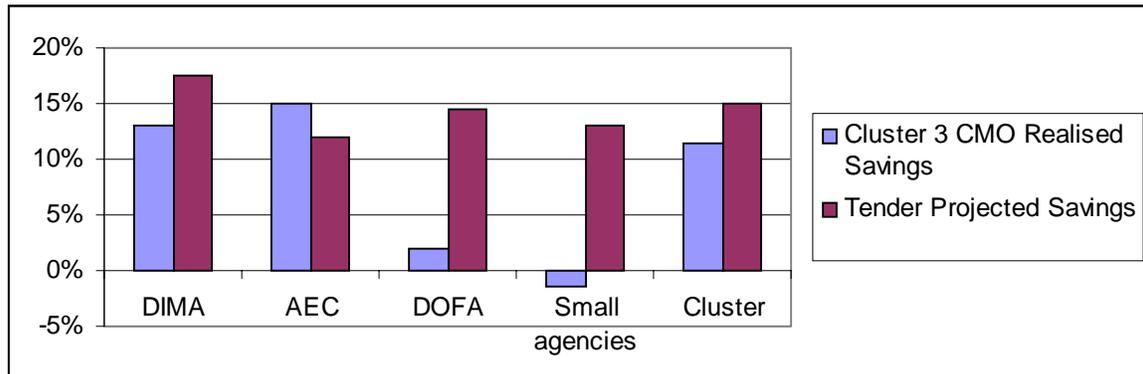
Footnotes 197 and 198 in paragraph 8.51 (above) are reproduced in footnote 15 to illustrate some of the difficulties associated with defining what should be measured to estimate cost savings. Figure 8.1 referenced in

¹⁵ Footnotes 197 and 198 in para 8.51 are as follows:

¹⁹⁷The savings model used in the tender evaluation to project first year savings included estimated voluntary redundancy (VR) payments and the payment to agencies by the ESP for existing equipment. The Cluster 3 CMO's analysis did not include these costs in either the normalised baseline or service charges considered. Taking those costs into consideration, the tender evaluation projected savings for the first year of the Agreement of 23 percent (\$9.88m) for the agencies considered by the CMO. Including the equivalent items in the CMO's savings analysis results in first year savings realised across the Cluster of 13 percent of the normalised agency baseline (\$6.7 million). A significant factor in the variance from expected savings is that actual DIMA VR payments were 3.5 times the \$1 million estimate used in the evaluation.

¹⁹⁸ IP Australia was projected to accrue savings of \$220,000 (34 percent) in year one, but realised a cost premium of \$209,000 (24 percent) over the normalised baseline. This was primarily due to an error in the tender evaluation which understated mainframe costs under outsourcing. IP Australia represents less than 3 percent of projected mainframe service charges over the term. Identified savings for AEC were greater than anticipated, partly due to a delay in the rollout of its desktop upgrade.

paragraph 8.51 (above) is reproduced in this paper as Figure 1. The Figure shows that not all agencies achieved cost savings in 1998-99, but it appears that some did.



Key: "DIMA" is the Department of Immigration and Multicultural Affairs, "AEC" is the Australian Electoral Commission, and "DOFA" is the Department of Finance and Administration (Minister Fahey's department).

Figure 1. Cluster 3 Contract Management Office's analysis of savings realized in 1998-99 compared to rate of savings projected for 1998-99 in tender evaluation. (Source: Data from ANAO [2000], Figure 8.1, page 196)

Summarizing, both measuring cost savings, and actually achieving them, is difficult. The examples above show that because of differences of opinion about what should be measured and how it should be measured, there is unlikely to be agreement on projected cost savings even on the date the tender is accepted. Thereafter, conditions change, and controlling for the effect of these changes makes it even harder to estimate cost savings. Measurement difficulties aside, actually achieving cost savings is also difficult. Table 2 shows that even in a competitive tendering situation, significant cost savings from IT Outsourcing seemed likely in only one of four tenders. Clearly, despite the enormous effort that went into the Australian Federal Government's Initiative, cost savings do not automatically flow from IT outsourcing. This conclusion was reached many times before (e.g., Lacity and Willcocks 1998, 2000, 2001, and Seddon et al. 2001], but it is rare to see the conclusion backed by such explicit, audited figures.

IV. CONCLUSION

Reading the various reports referenced in this paper it is clear that the Australian Federal Government's objectives in its IT Outsourcing Initiative were motivated by the most laudable objectives. The government sought to achieve the best value for money its information technology dollar and to support growth of smaller Australian-owned IT service providers. To ensure success, it paid "top dollar" to obtain advice from some of the world's most respected and experienced advisors, and at the most senior level, it tried its hardest to make the project succeed. The novel aspect of the Initiative was the decision to cluster departments to achieve economies of scale. A second key aspect of the Initiative was the decision to impose IT outsourcing from above, often, it seems, against the better judgment of senior management of the agencies and individual agency staff.

So did the Initiative succeed? If the Initiative had been defined from the outset as an experiment it could be classified as a success: experiments aim to achieve learning, and an awful lot of learning took place. In particular, the government learnt that because of increased coordination costs, clusters do not produce the expected economies of scale for whole-of-IT outsourcing. Secondly, the government learnt that getting people on-side matters: all the way from senior management to the lowliest Help Desk worker. Third, the government learnt something that its advisors should already have known: that massive organizational change such as making the transition from insourcing to total outsourcing is hard. And finally, the government learnt that cost savings from total outsourcing are both hard to achieve and hard to measure. Lessons 2, 3, and 4 were learnt before, but somehow they had to be learnt again by both the Australian government and all its high-paid advisors.

However, the Australian federal government did not view the Initiative as an experiment; they simply wanted to acquire IT services more cheaply. From their

perspective, the Initiative was a failure: centrally-coordinated clustered-agency IT did not work as well as expected. Five of eleven planned contracts worth a total of A\$1.2 billion over five years are now let, and the agencies involved will have to live with (or renegotiate) these contracts in the coming years.

How did the theory, the ten commandments presented in the Introduction, stand up? A case study cannot “prove” the truth of any theory but contradictory evidence can raise serious doubt about the generality of a theory. In case of the three outsourcing contracts investigated in this paper, none of the evidence invalidates any of the commandments. Against the advice of Commandments 1 and 3, the government embarked on total IT outsourcing. It failed. Total outsourcing was abandoned. Against the advice of Commandment 2, the government sought to outsource *all* IT service provision rather than retain key IT staff to manage relationships with vendors. This action placed enormous strain on senior agency managers who, in the absence of qualified staff, were forced to become involved in micro-level IT management issues. Against the advice of Commandment 4, the government sought to impose IT outsourcing from above rather than letting senior managers in the different agencies choose to outsource services where they believed the economic case made sense. It was an article of faith that private-sector IT service provision would be more efficient than anything government public servants could provide. This action also failed. Individual agencies are now given authority to exercise their own discretion on which services are to be outsourced and which are not. These four high-level decisions, and the underlying “privatization is good” ideology driving them, more or less set the stage for all that followed.

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LIST OF ACRONYMS

ANAO	Australian National Audit Office (http://www.anao.gov.au/)
ATO	Australian Taxation Office (http://www.ato.gov.au/)
CMO	Contract Management Office
CSC	Computer Sciences Corporation (http://www.csc.com.au/)
DEETYA	Department of Employment, Education, Training and Youth Affairs, now DETYA (http://www.detya.gov.au)
EDS	EDS (http://www.eds.com/)
ESP	External service provider
HR	Human Resources
IBM GSA	IBM Global Services Australia (http://www.ibm.com)
IT	Information Technology
OASITO	Office of Asset Sales and Information Technology Outsourcing (http://www.oasito.gov.au/)

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