§ 4.02 Establishing the Business Case

A business case for a potential outsourcing arrangement is an analysis that helps the customer understand the financial benefit, if any, of performing the outsourcing transaction. On one side of the equation, that business case must analyze the customer's current cost of performing the services the customer proposes to outsource. The current costs are often referred to as the "base case."[1] The outsourcing business case compares these base case costs to the total costs of outsourcing the services over the proposed term. The total cost of outsourcing must take into account: (1) the ongoing outsourcing fees,[2] (2) one-time costs to transition the work to the service provider (i.e., the transition fees), (3) the costs of the services and resources that will be retained by the customer after outsourcing (i.e., the retained costs), and (4) the planning and transaction costs involved in putting in place the outsourcing arrangement.[3] The amount of the potential cost savings is the driver of the financial business case.[4] Stated as an equation, from a purely financial perspective, the customer should outsource if:[5]

Base Case > Cost of Outsourcing

In other words, the customer compares its aggregate internal costs (the base case) to the total costs of outsourcing over the term of the proposed outsourcing transaction.[6] Calculating the numbers on both sides of this equation

---

[1] Peters, "Pricing the Outsourcing Deal: Financial Drivers for Outsourcing Contracts," in *Outsourcing and Offshoring 2008: Protecting Critical Business Functions*, p. 178 (PLI/Corp. 2008).

[2] Ongoing fees should be the total estimated fees over the proposed term, calculated at their present value.

[3] See: Corbett, *The Outsourcing Revolution: Why it Makes Sense and How to do it Right*, p. 135 (2004), for an extended discussion of building the business case; Greaver, *Strategic Outsourcing: A Structured Approach to Outsourcing Decisions and Initiatives*, pp. 129-167 (1999), for a helpful discussion of all the cost elements involved in an outsourcing business case analysis.

[4] Corbett, *The Outsourcing Revolution: Why it Makes Sense and How to do it Right*, p. 12 (2004) ("In most cases, the cost savings are in the 10 to 20 percent range, but can be much higher . . ."); Tienstra, "In Outsourcing, It Often Doesn't Win to be the Lowest Price" (Nov. 2006), available at http://www.tpi.net/pdf/papers/In%20Outsourcing%20It%20Often%20Doesnt%20Win%20to%20be%20the%20Lowest%20Price.pdf (last visited June 8, 2011) ("When comparing sourcing alternatives, a well-established Base Case can build confidence in the savings projections forecast within the business case.").

[5] It should be noted that a customer may outsource for various reasons other than cost savings (e.g., access to skilled labor, to improve focus, to improve quality, innovation).

[6] Corbett, *The Outsourcing Revolution: Why it Makes Sense and How to do it Right*, p. 135 (2004) ("Building the business case for outsourcing . . . is basically just

can be difficult, however: both the total costs for the potential outsourcing transaction and the full scope of the customer's historical and projected future internal costs making up the base case.[7]

[1]—Base Case

Establishing the base case is essential to understanding the potential cost savings of the outsourcing transaction.[8] Before the customer can evaluate pricing proposals from potential service providers, the customer must first understand its own internal costs for the services it proposes to outsource. Customers rarely have an accurate understanding of their current costs for a scope of services.[9] The base case includes both internal costs (e.g., employee salaries and benefits) and external costs (e.g., software maintenance, telecommunication fees, lease payments, third-party service fees).[10] The types of costs that are included in the base case will vary, depending upon the type of service to be outsourced.[11] Some categories of costs that are often included in outsourcing base cases are:[12]

---

a matter of comparing the financials for the current, 'as is' operation to those for the proposed outsourced operation.").

[7] See: the discussion in § 4.03 *infra*; Corbett, *The Outsourcing Revolution: Why it Makes Sense and How to do it Right*, p. 135 (2004) ("[O]rganizations seldom have a very good understanding of their current costs; they often find it difficult to forecast the future with confidence; and they have a lot of different financial models to choose from when it comes to analyzing the numbers, each of which paint a very different picture.").

[8] Halvey and Melby, *Information Technology Outsourcing Transactions: Process, Strategies, and Contracts*, p. 322 (2d ed. 2005) ("An essential starting point in the outsourcing life cycle is the creation of a base case, or comparison baseline. The base case is a detailed determination of the operating costs of the IT services being considered for outsourcing (referred to as the in-scope services). . . . The result of this analysis should be an accurate representation of the expected costs for the in-house organization to provide in-scope services over the target term."); Datamark, "Preparing for Outsourcing: How to Build Your Base Case for a Cost/Benefit Analysis" (Aug. 27, 2010), available at http://www.datamark.net/resources/articles/preparing-for-outsourcing-how-to-build-your-base-case-for-a-costbenefit-analysis (last visited June 8, 2011).

[9] Corbett, *The Outsourcing Revolution: Why it Makes Sense and How to do it Right*, p. 135 (2004).

[10] Peters, "Pricing the Outsourcing Deal: Financial Drivers for Outsourcing Contracts," in *Outsourcing and Offshoring 2008: Protecting Critical Business Functions*, p. 178 (PLI/Corp. 2008).

[11] Peters, "Pricing the Outsourcing Deal: Financial Drivers for Outsourcing Contracts," in *Outsourcing and Offshoring 2008: Protecting Critical Business Functions*, p. 178 (PLI/Corp. 2008). See Halvey and Melby, *Information Technology Outsourcing Transactions: Process, Strategies, and Contracts*, pp. 322-336 (2d ed. 2005), for an extended discussion on the elements of the base case for an information technology outsourcing transaction.

- Employee costs (e.g., salaries, benefits, taxes)
- Communications (e.g., mobile phone charges)
- Technology costs (e.g., laptop computers, software licenses)
- Equipment costs (e.g., depreciation or lease costs)
- Employee travel
- Third-party services (e.g., disaster recovery, consultants)
- Training
- Supplies
- Facilities and overhead (e.g., depreciation, rental and utility costs)
- Corporate overhead costs (e.g., legal, contract management, performing payroll).

Accurately calculating some of these current cost categories can be difficult. Building a comprehensive base case requires gathering data from a number of sources. With modern, complex corporate structures and global organizations, this can be a complicated process.[13] In addition, determining the proper allocation for assets and services that are used across a number of divisions or other portions of the organization can sometimes be more of an art than a science. It can be even more difficult to project base case costs into the future (which is necessary to build the base case). In order to build an accurate (and useful) base case, customers should expect to spend considerable time and effort.[14] Many customers engage third-party advisors to assist in the development.[15]

---

[12] Greaver, *Strategic Outsourcing: A Structured Approach to Outsourcing Decisions and Initiatives*, p. 131 (1999); Peters, "Pricing the Outsourcing Deal: Financial Drivers for Outsourcing Contracts," in *Outsourcing and Offshoring 2008: Protecting Critical Business Functions*, p. 178 (PLI/Corp. 2008).

[13] Peters, "Pricing the Outsourcing Deal: Financial Drivers for Outsourcing Contracts," in *Outsourcing and Offshoring 2008: Protecting Critical Business Functions*, p. 179 (PLI/Corp. 2008).

[14] Peters, "Pricing the Outsourcing Deal: Financial Drivers for Outsourcing Contracts," in *Outsourcing and Offshoring 2008: Protecting Critical Business Functions*, p. 180 (PLI/Corp. 2008) ("A customer should expect to spend a significant amount of time, effort, and money to properly build a complete base case."); Douglass, "What Every CIO Should Know About Outsourcing Cost Savings" (Dec. 2009), available at http://it.toolbox.com/blogs/strategic-sourcing/what-every-cio-should-know-about-outsourcing-cost-savings-35523 (last visited June 8, 2011) ("You will need a very good financial base case, which includes all your costs to deliver the service—not an optimistic, feel-good model, but a realistic model that accounts for things such as overhead costs, shadow organizations, and both internal and external resources.").

[15] Douglass, "What Every CIO Should Know About Outsourcing Cost Savings" (Dec. 2009), available at http://it.toolbox.com/blogs/strategic-sourcing/what-every-cio-should-know-about-outsourcing-cost-savings-35523 (last visited June 8, 2011) ("It is advisable to get someone outside the organization to help with this model. A professional sourcing advisor can bring a third-party perspective to the development of a

Once the base case is developed it can be used as the baseline to evaluate the fees proposed by the service providers. However, the base case is not all about numbers. Building the base case analysis can also be useful in identifying and validating the proposed scope of outsourcing services. Because building the base case requires a structured and thorough analysis of all aspects of the function proposed to be outsourced, this process often uncovers service areas related to the function that were not originally contemplated by the customer or that the proposed service provider failed to take into account. This process can help give the customer and proposed service provider a better definition of what is "in-scope" in the outsourcing transaction and what activities are to be retained by the customer.[16] A well-documented base case with detailed descriptions of the included functions can serve as a useful contract attachment that helps to define the scope of the services subject to a "sweeps clause."[17]

[2]—Cost of Outsourcing

The total cost of outsourcing includes (1) the ongoing outsourcing fees, (2) one-time costs to transition the work to the service provider (i.e., the transition fees), (3) the costs of the services that will be retained by the customer after outsourcing (i.e., the retained costs), and (4) the planning and transaction costs.

[a]—Ongoing Fees

The ongoing fees are the normal periodic fees to be charged by the service provider during the proposed term of the outsourcing transaction. The calculation of ongoing fees can be complicated and can change over time. Ongoing fees are often tied to variable resources, such as transactions (e.g., number of calls, number of checks processed), resources in the customer's

---

solid baseline that is comparable to the deal you are about to undertake."). See § 2.01[2][a] *supra*.

[16] Peters, "Pricing the Outsourcing Deal: Financial Drivers for Outsourcing Contracts," in *Outsourcing and Offshoring 2008: Protecting Critical Business Functions*, p. 178 (PLI/Corp. 2008).

[17] Malven, "Technology: Outsourcing Transactions—Strategies, Tactics and Gotchas—Part 3: Take particular care in defining the scope of the services and the parties' respective rights to terminate" (Dec. 2010), available at http://www.insidecounsel.com/Exclusives/2010/12/Pages/Outsourcing-Transactions—Strategies-Tactics-and-Gotchas—Part-3.aspx (last visited June 8, 2011) ("The standard approach for outsourcing customers to mitigate the risk of insufficient service descriptions is to include what is known as a 'sweep clause' in the outsourcing contract. These clauses will (i) include within the contract scope additional services that are incidental to the specifically enumerated services in the Statement of Work, and (ii) in certain cases, use additional means to define the contract scope such as by including within scope all work being done by the people or department being transitioned."). For an extended discussion of the sweeps clause, see § 3.01 *supra*.

environment (e.g., number of computer desktops, number of employees), or an amount of labor expended by the service provider (e.g., fee per full-time person used). However, ongoing services can be priced using many different and often complex models.[18]

[b]—Transition Fees

Transitioning the outsourced services from the customer to the service provider is a significant, one-time project.[19] This initial transition includes transfer of operational knowledge from the customer to the service provider, system integration, data migration, employee transition or severance, and other startup transition costs.[20] All of these tasks require the service provider to expend human and financial resources[21] that the service provider will look to recover either as a one-time transition fee or as costs incorporated in or "buried" in the ongoing fees.[22] These costs directly offset the anticipated savings associated with the outsourcing initiative, because many of the costs, such as severance or retention programs for personnel, are typically the responsibility of the customer.[23] In fact, these upfront transition costs sometimes mean that the first year of the outsourcing relationship will end up costing the customer more than before entering into the transaction. Both customers and service providers know that the customer will have a difficult time obtaining internal approvals if the costs for the proposed services are going to increase, even if only temporarily. Therefore, most service providers are willing to amortize these costs over a period of time (to diminish the

---

[18] For a discussion of various ongoing fee structures in outsourcing transactions, see § 4.03[1] *infra*.

[19] See Ch. 12 *infra* for an extended discussion of transition.

[20] Konvisser, "The Price is Right? When the 'Right Price' Uses the Wrong Methodology," in *Outsourcing and Offshoring 2007: Protecting Critical Business Functions*, p. 406 (PLI/Corp. 2007); Hewlett-Packard Development Co., L.P., "HP Business Process Outsourcing Transition Management Capabilities," p. 4 (April 2006), available at ftp://15.192.45.22/ftp1/pub/services/outsourcing/info/4AA0-4811 ENW.pdf (last visited June 8, 2011).

[21] A further discussion of additional cost during transition can be found in § 12.05 *infra*.

[22] Douglass, "What Every CIO Should Know About Outsourcing Cost Savings" (Dec. 2009), available at http://it.toolbox.com/blogs/strategic-sourcing/what-every-cio-should-know-about-outsourcing-cost-savings-35523 (last visited June 8, 2011) ("No matter how you slice it, you will have transition charges in the first year to pay the service provider for getting started: for moving resources, buying new equipment, and so forth. You can choose to pay these up front or upon completion of key milestones. Or you can finance up-front costs over the term of the deal. But the costs will still be there and will impact your overall business case.").

[23] Brown and Wilson, *The Black Book of Outsourcing*, p. 344 (2008).

effect early in the term).[24] Service providers will often apply an interest rate to these costs, treating them like a loan to the customer.

It is typical for the service provider to price the transition separately, allowing the customer to know these one-time costs.[25] This gives the customer the option to either pay these costs upfront or to appropriately analyze the impact of building these costs into the ongoing fees. In certain situations, a customer may even be able to obtain more favorable tax treatment for these one-time transition charges.[26]

It should be noted that building one-time transition costs into the ongoing fees can be risky.[27] If the transition costs are built into ongoing fees and the term is extended beyond what was initially anticipated, there is a risk that the customer will overpay. In addition, building transition costs into the ongoing fees complicates various early termination scenarios because the service provider will look to receive the unrecovered portion of the transition costs as a condition of, or a customer obligation upon, termination.

[c]—Retained Costs

The retained costs are the base case costs that will continue to be incurred by the customer even if the function is outsourced. These costs exist because, generally, not all of the functions related to the service to be outsourced can be performed by the service provider.[28] For example, an accounting supervisor's current function may be to monitor and manage employees in the company's accounting department. In an outsourced environment, that same individual may be in charge of managing the service provider who is now performing the customer's accounting functions. The employee's responsibilities have changed from managing employees to managing the service provider, but the function of management still exists and the costs associated with the employee are retained by the customer.[29]

---

[24] Halvey and Melby, *Information Technology Outsourcing Transactions: Process, Strategies, and Contracts*, § 6.8(d) (2d ed. 2005).

[25] Konvisser, "The Price is Right? When the 'Right Price' Uses the Wrong Methodology," in *Outsourcing and Offshoring 2007: Protecting Critical Business Functions*, p. 406 (PLI/Corp. 2007).

[26] *Id.*

[27] Douglass, "What Every CIO Should Know About Outsourcing Cost Savings" (Dec. 2009), available at http://it.toolbox.com/blogs/strategic-sourcing/what-every-cio-should-know-about-outsourcing-cost-savings-35523 (last visited June 8, 2011) ("Financing [transition costs] over the term of the deal has drawbacks, and deserves a closer look.").

[28] Greaver, *Strategic Outsourcing: A Structured Approach to Outsourcing Decisions and Initiatives*, p. 130 (1999).

[29] *Id.*

The nature and amount of retained costs will vary, depending upon the outsourced function. Some functions that are typically retained by the customer are quality assurance, strategic planning, contract management, audit, performance analysis, chargeback management and executive leadership.[30]

In addition to functions and costs that will simply continue after the function is outsourced, the "retained costs" portion of the equation needs to include additional ongoing costs that will be incurred by the customer as a result of the outsourcing. For example, a customer may need to hire a new employee with outsourcing vendor management experience to manage the service provider.[31]

[d]—Planning and Transaction Costs

Planning and transaction costs are all the one-time costs associated with evaluating, planning, structuring, negotiating and documenting the outsourcing transaction. These include staff time, travel, and all fees and costs paid to consultants, attorneys and other outside experts hired to assist the customer in the outsourcing process.[32] Planning and transaction costs also include the time and costs needed to construct the base case; develop the request for proposal ("RFP"); evaluate the RFP submissions; perform due diligence on the proposed service providers; construct the outsourcing contract documents; negotiate the terms; and perform any other necessary steps needed to enter into the outsourcing contract.[33] Typically, these costs are a small percentage of the annual cost of the outsourcing arrangement but are not insignificant.[34] In fact, in certain transactions these costs can be more than $1 million.

---

[30] Halvey and Melby, *Information Technology Outsourcing Transactions: Process, Strategies, and Contracts,* p. 336 (2d ed. 2005).

[31] Peters, "Pricing the Outsourcing Deal: Financial Drivers for Outsourcing Contracts," in *Outsourcing and Offshoring 2008: Protecting Critical Business Functions*, p. 179 (PLI/Corp. 2008).

[32] Corbett, *The Outsourcing Revolution: Why it Makes Sense and How to do it Right*, p. 139 (2004).

[33] See Ch. 15 *infra* for suggestions on how to decrease negotiating time and transaction costs in outsourcing transactions.

[34] Pettey, "Gartner Says Companies Need a Better Understanding of the Costs Involved in Transitioning Internal IT Services to External Service Providers" (May 14, 2003), available at http://www.gartner.com/press_releases/pr14may2003a.html (last visited June 8, 2011) ("Typical costs for full advisory support through the vendor selection and contract negotiation phases range from 1 percent to 2.5 percent of the annual cost of the deal.").