

RUN AND TRANSFORM

Application Services and the New Sourcing Paradigm

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EXECUTIVE SUMMARY

Once a peripheral topic at board meetings, technology is increasingly becoming a core element of business strategy and corporate identity. “Google” as a verb, “digital” as a noun and the “uberification” of everything underscore the extent to which technology has disrupted and redefined how business leaders approach their jobs. In this environment, effective IT outsourcing is more important than ever, and while cost reduction remains a priority, enterprises increasingly focus on leveraging technology to aid competitive differentiation and foster innovation, open new channels of service delivery, expand and penetrate customer base and foster revenue growth.

In response to these imperatives, many organizations are adopting a management approach to application services that makes a specific distinction between “Run the Business” application services on the one hand, and “Transform the Business” services on the other. Characterized by different operational and organizational structures as well as specialized processes, methods and metrics, this “bi-modal” model is designed to optimize the security and stability of IT operations, while at the same time enabling agility, flexibility and rapid response to changing business requirements.

This ISG white paper, co-authored by Wipro’s head of Application Management Services, examines key trends shaping the “Run” and “Transform” streams of IT organizations, focusing specifically on implications for sourcing strategy as they relate to Application Development and Maintenance Services.

THREE TRENDS SHAPING RUN

Increased Adoption of Cloud

Adoption of cloud-based solutions is driving a new application paradigm of standardization. The days of customization and complex configurations are over, as emerging “hybrid” IT environments are characterized by the co-existence of commercial off-the-shelf (COTS) products together with bespoke applications as well as some SaaS solutions for back-office services.

In some cases, point solutions (typically cloud-based) are used to fill a specific business need. These pose different technological and governance-related challenges for both customer and service provider. Key questions include: How can a landscape with applications in multiple architecture silos that need to be orchestrated seamlessly to ensure business continuity be best supported? Should providers deliver ADM services in a private, hybrid or public cloud? How do these choices affect pricing structure?

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Measuring the Business Impact of IT Operations

Website outages experienced by some major US-based retailers during Black Friday and Cyber Monday underscore the adage that “disruption to IT is now disruption to business,” and clearly illustrate the direct impact of IT Run operations on business performance. Meanwhile, Amazon’s guaranteed same-day delivery, investment into two-hour guaranteed delivery and exploration of drones as a delivery vehicle highlight the competitive dynamics driving an imperative for continuous improvement in Run capabilities.

This critical dependence on IT is driving demands for business-based measures and, specifically, greater visibility into how IT operations are linked to business performance.

For example, metrics such as order to shipment process uptime and customer order fulfillment index are increasingly appearing in IT managed services contracts, in addition to traditional IT metrics such as mean time to repair, uptime and P1 incident reduction.

To deliver on these commitments, service providers expect clients to contract for broader service coverage – including applications, infrastructure, and devices – as well more control over ITIL process initiatives and potentially expensive toolsets to enable the required level of rigor and process discipline.

Convergence of IT and OT

Operations Technology (OT) is the branch of computing applied to control, monitor (and in some cases correct) the devices, equipment and machinery used to operate a plant or factory.

For example, Supervisory Control and Data Acquisition (SCADA) for a power plant controls the entire operations of the power plant – from the boiler to the generator to the isolating transformer that connects a power plant to the grid. In the process industry, OT ensures the control and flow of ingredients into a can of a fizzy drink, monitors the temperature and humidity of a fermenting vat and checks pieces of chocolate coming through the line and rejects those that are unwrapped.

The integration and convergence of IT and OT enables the delivery of greater value to the customer. For instance, information about demand patterns can feed into a power plant’s SCADA to prevent overfeeding the grid and needlessly consuming fuel. In addition, data from daily power auctions can be programmed into the SCADA system to adjust power generation.

Enterprises can seize the opportunity of convergence to leapfrog competitors who lag in adoption. However, as firms seek to leverage this trend, business models will increasingly depend on the continuous and successful operation of this integrated IT/OT estate. IT divisions will face pressure to structure their service provider contracts to ensure the continuity of such operations, and as time goes by, to improve service performance while lowering costs.



THREE TRENDS SHAPING TRANSFORM

IT Service Providers More Involved

In a new economy characterized by disruptive upstarts and ever-lower entry barriers, businesses are becoming acutely aware of their vulnerabilities. In response, enterprises seek technology experts (a.k.a. service providers) to develop innovative approaches to operating in a digital world and an As-a-Service economy. While traditionally viewed as order takers who did as they were told (for less money), service providers today are increasingly expected by their clients to deliver thought leadership and concrete proposals on how to be more competitive and boost revenue.

Transformed IT Landscape

Enterprises seeking to leverage innovation must move to an IT architecture characterized by loosely coupled, best-of-breed components. The end-state of this architecture is the ideal “plug-and-play” landscape, where applications can be rapidly commissioned and de-commissioned with minimal disruption. Some of the applications in the transformed landscape could be on the public/hybrid cloud, or consumed as a service. Legacy applications, meanwhile, could be on-premise or hosted.

The disaggregated nature of the target end-state – be it the applications, their underlying technologies, databases, related unstructured data or infrastructure – all introduce complexities during transformation and, in turn, to outsourcing in the transformed IT landscape.

Growth of Third-Party IP

Service Providers are increasingly bringing IP in areas such as analytics, automation, cognitive computing and artificial intelligence to client engagements. In addition, providers are continuing to deploy domain-led proprietary frameworks and solution components to accelerate development and time-to-market and ensure ease of operations and feature changes. As disaggregated (multiple), best-of-breed solutions are applied to business processes, the number of partners and IP owners involved in the mix to support the business is on the rise. While this provides an opportunity to leverage the specialization of multiple providers, it comes with the challenge of managing complexity and ensuring collaboration among disparate teams.

OUTSOURCING CHALLENGES FOR RUN IT

The key trends outlined above have a significant impact on sourcing strategies as they relate to the Run side of IT. For one thing, shaping a deal based on business level SLAs in a hybrid environment necessitates choosing one of the following two options:

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- Giving the entire operations to a single vendor who can deliver end-to-end services.
- Creating a separate service integration and management layer (staffed in-house or by consultants) to provide an end-to-end view of the entire service performance and deliver to business level SLAs.

In addition, specific key questions to consider include:

- How should services be scoped and carved out in an unambiguous manner?
- How should the entire IT landscape be sized?
- How should service performance be measured in this environment?
- What kind of service level agreements should the customer enter into with these service providers?
- How can a single point of responsibility be created when the underlying contractual constructs may not support it?
- How should customers pay for the service provider's IP?

OUTSOURCING CHALLENGES FOR TRANSFORMATION

In contrast to a traditional project, transformational programs tend to have a significant “venture” element. Key outsourcing considerations include:

- *Opportunity cost* of committing to a transformation journey ahead of competing options for the customer. The time lost in a poorly strategized or inadequately executed transformation venture can set a business back by years and seriously impact competitive advantage. Such risks are difficult to quantify or negotiate and typically cannot be shared with the service provider.
- *Financial uncertainty* for the service provider, with the potential for a negative impact on margin or a loss of revenue. For a traditional service provider accustomed to reasonably predictable revenues and returns, the risk of a transformational project can be unpalatable and preclude management buy-in. Moreover, service providers would expose only a small share of their revenue to such risks by limiting the number of such deals they pursue. This would shrink the pool of providers willing to execute such contracts, thereby limiting the competitiveness of such bids and the negotiating power of customers.
- *Uncertainty* of the business environment could render business outcome-based contracts irrelevant before completion of the transformation program. Assigning success and failure independent of often unavoidable external influences becomes subjective and can have serious consequences in the absence of a carefully constructed sourcing relationship.
- *Scheduling* the multiple projects that are executed by multiple vendors and service providers can be a complex task with little wiggle room for slippages. Building adequate



buffers may not be possible, since some projects can be difficult to size, estimate and schedule. Competitive pressures can add to timelines getting squeezed – further increasing schedule risks.

- *Co-existence* of the current state and future state landscape for a potentially significant period of time. Identifying responsibilities between the different service providers during this overlap can be problematic, especially if a legacy service provider is delivering services under an older contract that does not address the new paradigm.
- *Uncertainty* of some transformation projects makes it difficult to define unambiguous acceptance criteria that both customer and service provider will agree to.

Additional considerations involve the role of IP in the initiative. Specific questions include:

- If the service provider's IP becomes a crucial competitive differentiator for the customer, how can the benefits continue beyond the end of the contract?
- Even if the service provider allows for a perpetual end-user license, what skills can be procured if the IP requires maintenance at some point?
- How are usage limits of IP defined post the end of the engagement? Can the customer continue to use the IP?
- What is the service provider's responsibility if a serious bug that disrupts the customer's business is uncovered after the end of the contract? Is the service provider obliged to deliver a fix, or at least inform the customer of such a problem?
- While customer data used for cognitive computing initiatives will not be transferred along with the IP back to the service provider, what about the learning that happened in the cognitive tool as a result of the data?

THREE COMMERCIAL MODELS

As business requirements for IT services evolve, commercial models will need to respond accordingly. These models depend on measurability of either input (effort) or output (service performance, acceptance of milestone deliverables) to define unambiguous contract terms, and must be fine-tuned to adjust to changes occurring in engagement structures and new technologies.

Outcome-Based Models

"Outcome-based" models have been in use for a while, with the phrase being applied rather loosely to denote any contract outcome (even meeting an SLA) as the consideration for the contract. In a stricter sense, the model denotes a specific set of measures that tie IT spend to a business demand or a business outcome.



Examples include rate per customer billed, rate per user subscribed, pricing related to assets under management.

The challenge of this model is to clearly isolate the influence of transformed (or better run) IT on a business outcome. For instance, if an engagement is accompanied by increased sales, how can a customer determine if that increase was driven by the vendor's performance, rather than by an effective marketing campaign? By the same token, if the value of an engagement is tied to increased sales, the vendor can be unfairly held responsible for sales execution, since the customer may err on their strategy, fail to execute their strategy or be impacted by unforeseen events.

As such, business outcome measures must be chosen carefully and should contain exception clauses so that vendors are unfairly penalized. Measures such as increase in share of sales through online booking, or increase in revenue through opening up a channel through social media can be effective measures of business outcome.

Alternately, commercial terms can be tied to IT volumes that are indicative of business outcomes or business objectives. For instance, "rate per user" pricing can be used if user volume directly influences sales, or if users opt for a lower cost channel or medium for communication. For instance, if end-customers use a less expensive online channel for complaints rather than calling up a more expensive service desk, then the number of complaints logged using the online channel can be used as the measure to determine pricing.

Outcome-based pricing models will become more prevalent with the strengthening of the trends discussed earlier. Customers who use this model effectively can benefit from both the variability it affords as well as the incentive it holds for the vendor to go above and beyond what is contracted for.

Catalog-Based Models

By nature, agile development is characterized by a progressive and dynamic identification of requirements. As agile development gains traction, scoping projects a priori therefore becomes increasingly difficult. Reverting to traditional T&M pricing, meanwhile, is unappealing to customers as it lacks productivity measures to assess value for money.

A catalog-based pricing model can be customized to meet this requirement. For instance, a story can be classified into different categories based on complexity parameters (and even sizing measures such as story points) and priced. An example is tabulated here.

Cost/object Complexity	R-Report	I-Interface	C-Conversion	E-Enhancement	F-Form	W-Workflow
Low	Xx1	Xx2	Xx3	Xx4	Xx5	xx6
Medium	Yy1	Yy2	Yy3	Yy4	Yy5	Yy6
High	Zz1	Zz2	Zz3	Zz4	Zz5	Zz6



This model requires the vendor to have a flexible people ramp-up and ramp-down capability. However, the customer and the vendor must retain a core team to prevent knowledge loss and respond to changes in demand by increasing or decreasing capacities. This model can work well where the technical competency needs are not too widely dispersed.

Gain-Share Models

As the name suggests, under this model the customer and the vendor share in the savings achieved by streamlining IT operations or by implementing a transformational program that results in savings. Typically, such gains are applied to an innovation fund or a center of excellence to help the customer address other business needs.

In contrast to the outcome-based model, which focuses on business outcomes, gain-share models are based on reducing IT costs.

Customers with significant application portfolio rationalization needs, or with IT operations characterized by non-standard, disparate and informal processes and inadequate tool usage can benefit from this option.

SUMMARY

Businesses today face increasing pressure to drive continued cost reduction through operational efficiency, while at the same time investing in innovative technology solutions to drive revenue and competitive advantage. Many IT organizations are responding with a management approach that makes a distinction between “Run the Business” application services and “Transform the Business” services. This approach is designed to more effectively address the requirements of IT to drive operational efficiency and stability coupled with agility and innovation.

The evolving bi-modal IT model is having a significant impact on sourcing strategies, which increasingly must address complexities of multi-architecture IT landscapes and best-of-breed multi-vendor service delivery models.

As IT becomes increasingly important to business, IT outsourcing requires effective planning and direction, as well as flawless execution.

Pricing and commercial models, meanwhile, must incentivize both the customer and the vendor to collaborate to achieve business objectives and resolve the complexities characterizing IT services in today's business environment. While traditional pricing models continue to have relevance, emerging models can effectively address some of the challenges confronting CIOs.

ABOUT THE AUTHOR

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Carlos Amaral leverages his more than 20 years of experience in the IT industry to help clients achieve the desired results from the sourcing process. Carlos' comprehensive experience includes activity-based costing, F&A, sourcing strategy development & execution, contract negotiations, relationship management, Cloud Computing & SaaS, and outsourcing deal evaluation & shaping from an ITO, ADM, and BPO perspective.



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