

“Outsourcing- The New Growth Paradigm”

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Abstract

Outsourcing has become a compelling necessity for the companies vying to compete globally. Every company is now outsourcing one or more of its activities to external agencies. The company sees benefit in outsourcing by way of cost saving and their ability to focus on core business as well as a core competency thus acquiring cutting edge which matters most.

Although the concept of outsourcing is centuries old, yet it is revisited every day to derive its fullest advantage in the era of economic perestroika. It is, therefore, essential to distinguish the areas of activities critical to the firm or the areas of core competence that the firm wishes to retain with them. Vendor selection is another important area upon which success of outsourcing depends heavily.

In this article experience has been shared on the mechanism of outsourcing as well as its management and growth model with specific reference to the steel industries.

Key words: outsourcing, cost saving, management, steel industries

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1. Introduction:

The Holy Roman Empire to Wall Street – the common denominator of outsourcing

Subcontracting, is a concept that originated many millennia back in the innovative mind of some unknown Roman or Greek general, who hired the first mercenary to fight along with the regular soldiers of the royal army. In India, Sher Shah Suri and later Akbar embellished this concept by introducing the man-sab Dari system, wherein man-sab Dari were given the task of collecting revenue on behalf of the king. Thus, kingdoms which can truly be considered as being precursors to today's corporate behemoths, had understood that the kind should focus on core matters of annexation, alliances and governance-the rest could be sub-contracted or outsourced.

What kings could do, today's corporate czars, fed on the ever-burgeoning fare of latest management literature and jargon, did even better. Company's diversification was the rate in the '60s and '70s as companies tried to spread their options and hedge their bets against downturns in their core activities. However, in the 1980's the pendulum swung in the opposite direction, as diversification went out of favor. Management gurus recommended that the way to pecuniary salvation lay in selling off non-core businesses and concentrating only on those activities where the company had built up a wealth of expertise – thus, even certain peripheral activities were brought within the functional ambit of the firm.

But then came the economic Perestroika of the late '80s and early '90s, which made it imperative for companies to embark on an extensive bout of cost reduction. This leads to a massive dose of downsizing, which brought about a realization that it was not possible to execute all its earlier tasks with the dwindling workforce. The only way to survive was to engage contractors, job workers, part-time managers to do the non-core functions; core functions were still retained by the firm.

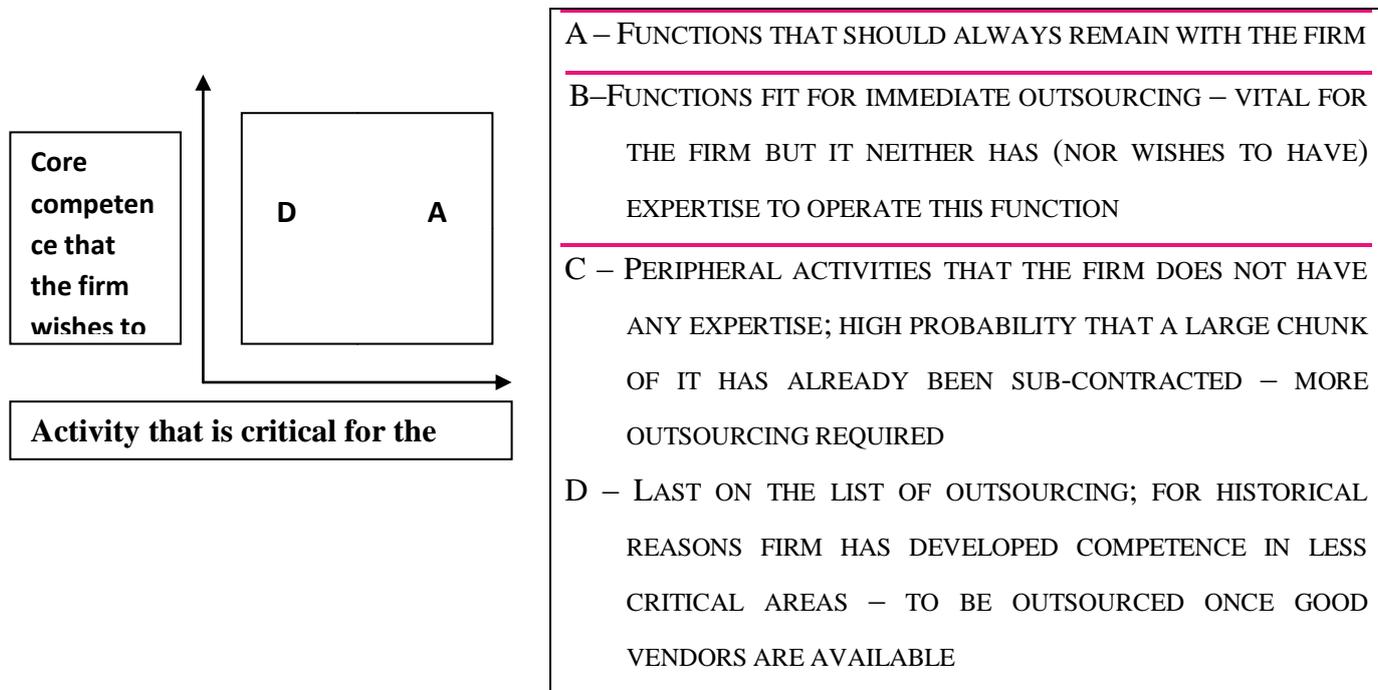
From sub-contracting to outsourcing – Handy's doughnut

The subcontracting activity of the early '90s leads to immediate gains in cost reduction – but not necessarily improvements in the processes, as the deliverables of a sub-contracting contract had more to do with measurement per diem, rather than with service level agreements. A typical sub-contracting exercise would not be monitored by the area cleaned – rather than the cleanliness of the area; nor did the contracts have any in-built incentive for contractors to strive in bringing down the per unit cost or do the same activity with a greater level of innovation.

Thus, there was a growing realization among the corporate fraternity that sub-contracting had to be viewed differently in the process to result in a win-win situation. Charles Handy's famous example of comparing a modern organization to an "inside-out doughnut", where the inside dough represents the core of the firm, is proving to be the most enduring models for outsourcing. Handy's model does not imply that the firm has no role to play in the space surrounding the core activities. Indeed, most firms are perplexed at having to encounter this fuzzy realm of make vs buy and having to take a decision that has to do more with esoteric sounding concepts like strategic intent rather than mere comparison of in-house cost vs outsourcing cost.

Instead of merely sub-contracting non-core activities, it was realized that the company's decision to outsource should be based on the twin dimensions of core competence and core activity. Thus, outsourcing is now being viewed as a strategic exercise – the functions identified for outsourcing represent vital areas for the company but the company is not in a position to devote manpower or capital for the development of these functions. A discounted cash flow method is being adopted by most firms

to buttress their strategic decisions of outsourcing, so that the decision-making process has both qualitative and quantitative dimensions.



Thus, the primary activity of a firm that wishes to embark on the process of outsourcing is to define its set of core competence, BOC decided that its core competence lay in making gas, distributing it and its application to industrial/domestic uses. It examined its annual spend of 2.6 billion pounds covering 253 areas of expenditure and identified areas for outsourcing.

Simultaneously, realizing its competence in distributing chilled food using liquid nitrogen as a cooling agent, it started a new venture with Marks and Spencers for delivering M&S's fresh foods to its 300 stores across the UK. Similarly, the British retail chain giant, Littlewoods, while realizing that a good restaurant plays a crucial role in attracting customers, realized that it would rather garner competence in its core area of merchandising and retailing, and outsource the important activity of catering to industry leader, Granada Food Services. This leads to a 375 million pound contract spanning seven years and involving a transfer of 2000 staff from Littlewoods to Granada.

The Dramatis personae

THE OUTSOURCING INSTITUTE, A U.S.-BASED OUTSOURCING CONSULTING INDUSTRY HAS PEGGED THE SIZE OF THE U.S. OUTSOURCING MARKET AT \$100 BILLION. IN THEIR PERCEPTION, THE MAJOR AREAS ARE (AS SHOWN IN THE ADJOINING FIGURE):

A: 15% - REAL ESTATE-FACILITY MANAGEMENT

B: 40% - IT

C: 30% - ADMINISTRATION/HR/PAYROLL/ CUSTOMER SVCS

D: 15% - LOGISTICS

THE JULY '98 REPORT OF THE FOUNDATION FOR MANUFACTURING & INDUSTRY, UK HAS ALSO REPORTED A SIMILAR TREND IN THE UK WITH 133 CONTRACTS SOLELY IN THE AREA OF ITS OUTSOURCING

Though IT outsourcing is the most common form of outsourcing encountered in literature as well as industry, other business functions are also being outsourced. The petroleum giant, Shell used to earlier manage its service stations with Shell staff and even deliver fuel in Shell tankers by Shell drivers. Shell realized the redundancy of doing these jobs in-house – and subsequently outsourced its logistics function. Benetton has grown from strength to strength based on the concept of outsourcing – its products are sold in 120 countries through 7000 shops, culminating in a turnover of 1 billion pounds. Benetton only concentrates on its core competence of design – the actual process of manufacturing is outsourced to small workshops in northern Italy, while the retailing is outsourced to its franchises. This has worked out to be win-win situation for both the contracting parties, furthering the growth prospects for both concerned.

This exponential growth in the outsourcing industry has been due to the development of suppliers in the market who are capable of providing world class goods and services. The strategic objective of outsourcing has to be complemented with the availability of good vendors – outsourcing should be done, only if there is somebody else, who does it better than the client firm – else it should be kept in-house, till a suitable partner is developed.

Contrary to our perception, which was based on our experience with vendors who did sub-contracting jobs, the suppliers considered for outsourcing contracts are neither hole-in-the-wall kind of firms nor are they fly-by-night operators. They are usually industry leaders operating across several countries with a qualified and large workforce. Their secret to success lies in the fact that they have

concentrated on doing only that activity (or cluster of homogenous activities) at which they possess competence and have been able to derive economies of scale due to their large scale operations.

Copenhagen-based International Service Systems (ISS) is a highly successful \$2 billion company with operations spanning seventeen countries across three continents. Its area of expertise and operation is the commercial cleaning business – a far cry from the one-man-show business that one is usually acquainted with in this line of business. Another such global service provider is MSX International, the US-based \$ 1 billion turnover company that has 11,000 employees and contract personnel in 23 countries. It is a one-stop shop for procurement services, office management, etc.

The mechanics of outsourcing – SESPA and complex contracts

The success of an outsourcing contract depends on the availability of a good vendor and the ability of the firm to enter into a partnering relationship with this vendor. With the age of an outsourcing contract normally averaging between 7-10 years, the process for choosing such a partner becomes significant. The decision cannot be driven by price alone nor can the commercial arm of the organization be the sole decision-maker.

This is a cross-functional activity, wherein at the outset of each outsourcing exercise, all the stakeholders try to decide what the organization aims to gain from this exercise. An ambiguity in the minds of the users translates into even greater confusion for the service provider. BOC, was a pioneer to realize this dilemma and they formulated a model known as SESPA, which captures the attributes that it desires from a vendor and helps supplier selection as well as performance monitoring. SESPA stands for supplier evaluation and selection, which should help to identify the best vendor and the PA connotes performance appraisal to ensure that the vendor retains its attributes throughout the duration of the contract.

The cornerstone of this approach is that suppliers are upfront informed about the attributes against which they would be assessed – this is a diametrically opposite approach to traditional purchasing where the sharing of information is minimal. While framing the specifications for outsourcing of BOC Gases Australia's legal services, a cross-functional team defined thirty-two separate criteria deemed important for such a supplier. These included responsiveness, market knowledge, communications, use of technology, competence in the requisite fields – price was reflected only in four of these thirty-two attributes. Similarly, while outsourcing its travel arrangements, the requirement was for a global player and a sample of the thirty attributes is global coverage, ability to capture information, control of operations, training scheme, safety, etc.

The parameters for selecting a supplier would depend more on qualitative attributes like prior experience in executing similar contracts, compatibility of the culture and values of the supplier and the client, the quality of its process and people, responsiveness, innovativeness, financial and cash flow position rather than merely the price attributes. In fact, there may be cases where the initial cost of outsourcing may be higher than the current in-house cost. The gains start percolating after a couple of years when improvements and innovation is brought about by the supplier (by virtue of its being best in the field) and then the cost related benefits of outsourcing also become visible.

Since the vendors would henceforth manage a lot of critical functions, there is an element of risk involved as the non-performance of the vendor may directly affect the business. Due diligence has to be exercised by the firm in terms of assessing the capability of the proposed vendor and calculating the loss that would accrue due to the failure of the vendor.

While contract framing is essentially very elementary in sub-contracting exercises, it takes on a very complex hue in outsourcing contracts. This is primarily due to three reasons:

- Evolving discrete service level agreements and framing systems to monitor the same – e.g. – instead of computing the quantum of chemicals used to clean the water, a measure to gauge the cleanliness of water has to be evolved for a chemical supplier.
- Asset transfer is a de rigeur for most outsourcing contracts, whereby these are leased/hired/sold to the vendor. This involves an aspect of security (primarily in the case of IT outsourcing wherein the transfer of information databases is involved), patents, trademarks and licenses. Also, with the possibility of the activity being insourced at a later date, adequate exit clause along with safety clauses have to be built into the contract to ensure that the condition(physical/ownership/title) of the asset remains unaltered.
- Transfer of employees is also an integral part of many outsourcing contracts and thus framing of clauses to safeguard the privileges and compensation of these employees is an important task.

Thus an outsourcing contract comprises three separate agreements:

- Services agreement,
- Business transfer agreement (licenses, insurance, hardware software, etc.) and
- Resource transfer agreement (hire/lease of property, C&B for personnel)

Managing an outsourcing contract – Organizational Maturity

Monitoring of these contracts becomes a key success factor for ensuring that both the parties involved in the contract retain their level of satisfaction year after year. It requires some finesse to outsource a complete business function with its staff and assets to a third-party and still retain a measure

of control over the outcome. The danger is that the client company's management controls will remain in place, duplicating those of the supplier and also choking his innovation. Simultaneously, the client firm also experiences a loss of control, as outsourcing leads to a lot of critical functions being managed by the vendor.

Ambiguity in the expectations from both sides also leads to a host of dissatisfaction. Statistics reveal that 70% of outsourcing contracts have led to client firms expressing their disappointment with either the vendor or the nature of the contract, and they have insourced these functions after experimenting with outsourcing for some time. Though delineating the service level expectations to the vendor at the beginning of the contract and building systems/structure to monitor the same, will definitely bring succor; a change in the organizational mind-set in viewing the activity of outsourcing is a pre-requisite for this activity to succeed. Having operated for aeons under the traditional arms-length relationship with vendors, it becomes difficult to adapt to a relationship that veers more towards a partnership model. This is a learning that has to be undergone by each organization that wishes to outsource – the degree of the organizational maturity fashions the pace at which an organization comes to terms with the activity of outsourcing.

Apart from learning to manage its partners, the organization has to contend with certain contentious issues of legal and HR. While formulating such contract compliance with the norms of the various legal statutes --Contract Labor (Regulation & Abolition) Act, '70 (in terms of principal employer) and other laws pertaining to the welfare of contract employees is essential. Also, managing the HR scenario requires a special skill set as all employees feel insecure about their future. Employees who are being transferred to the vendor are not any more certain of their employment tenure and employees who still remain on the company's rolls feel threatened by the fact that they too may face the same fate, in case their function too gets outsourced.

2. Outsourcing experiments in the Steel Industry

For the last ten years, steel makers all over the world have started using outsourcing opportunities mainly in the area of information technology (IT). Bethlehem Steel initiated a study in 1992 for examining the feasibility of outsourcing its IT services. A 10 year, \$ 500 million full service contract (involving transition of 400 Bethlehem professionals) was negotiated with Electronic Data Systems (EDS) on 1st Jan '93 for the following areas:

- Data center consolidation
- Systems development and maintenance
- Personal computer acquisition and management

- Voice and data network management
- Selected process control assistance

The possibility of cost savings and the expertise of EDS in this field dictated the rationale for the contract as well as the choice of the outsourcing partner. After 6 years of the contract, Bethlehem Steel is very satisfied with the results. Its computing infrastructure as well as training of personnel has definitely shown a positive trend, though the experience has been less than favorable in the area of process control. This satisfactory relationship has been due to the contract provisions in areas such as management councils, incentives and penalties.

Also, both the organizations have built strong interpersonal relationships based on many shared values, especially integrity and continuous learning.

Usiminas, the Brazilian steel maker has gone a step ahead and has managed to outsource many of its non-core (but essential) activities through innovative outsourcing agreements. The inception of Usiminas was marked by the steel firm having to take upon itself the responsibility of creating and executing many employee-related service delivery vehicles. Hospitals, airstrips, schools, parks were created and managed by Usiminas. However, the realization dawned in the late eighties that Usiminas would benefit by concentrating on steel making, and outsourcing the rest to capable vendors. Thus, a cooperative was given the task of managing the hitherto Usiminas hospitals; a similar model was adopted for the social services. The outsourcing experiment has been a successful one at Usiminas, and is a beacon for other companies wishing to embark on this path.

British Steel is also slowly outsourcing the management of its routine shop floor activities to its bigger vendors, thereby unifying the responsibility of ensuring supplies as well as executing the job/guaranteeing uptime to a single node. These bigger vendors also undertake the responsibility of managing the multiple smaller vendors who are also associated with similar activities. This transition towards Business Process Outsourcing is anticipated to enhance productivity as well as service levels.

3. Exploring outsourcing at Tata Steel

Inadequate vendor capability coupled with the old management paradigm of wishing to do all jobs in-house, leads to Tata Steel setting up facilities across a wide spectrum of activities that span the total gamut of highly technical to purely social. Tata Steel thus, developed in-house competence ranging from refractories, rolls, motor repair, machining to managing schools, hospitals and parks.

With outsourcing gaining the respectability of a successful business model as well as availability of world class vendors, there is an effort within Tata Steel to outsource functions that are not directly related to steel making. Though a lot of peripheral activities had been always been sub-contracted out at Tata Steel, a conscious effort has just started to outsource from a process perspective. A modest beginning has been made with the outsourcing of its travel services and certain select schools and parks. A similar experiment is also being carried out on the operations side to identify activities/processes that can be dealt more capably by a third party service provider.

One of the pioneering outsourcing experiments on the operations side was the outsourcing of oxygen refining to world leader, BOC. Oxygen forms a critical input for steel making and the commissioning of LD 2 enhanced our requirement for oxygen. Tata Steel was faced with the choice of either expanding its in-house oxygen production facility or outsourcing the services to a third party service provider. The second option was preferred, as Tata Steel did not wish to build competence in this field and BOC was chosen for providing this extremely critical input. BOC's credentials in being the world leader in this market as well as Tata Steel's long standing relationship with BOC in its supply of industrial gases were instrumental in BOC being chosen as our outsourcing partner. The success of this experiment lay in this contract being a reciprocal relationship between the two contracting parties, and the congruence of the business goals of each firm with the role that was being played by each in this contract.

4. Conclusion:

The growth model – Partnering

Successful outsourcing contracts bear testimony to the fact that their success lay in the two parties having a reciprocal relationship. The client firm creates business for the supplier, thus helping the supplier to grow and the supplier by freeing up valuable resources of the client firm enables the client firm to pursue its main line of business. In fact, several new business opportunities have sprung up due to this increasing trend of firms outsourcing a greater proportion of their activities. Banks have been processing cheques since their inception and outsourcing of this activity would sound almost heretical to some. However, banks have realized that with an ever-increasing number of transactions being carried out electronically,

processing cheques is an area that they would wish to relinquish to someone more efficient, and they would rather concentrate on doing the electronic transactions better. EDS, the Texan computer firm sighted a business opportunity and offered their services in this field. Today, EDS processes two billion cheques for 1000 banks spread across forty countries. Similarly, Price Waterhouse Coopers, has established its Global Business process Outsourcing Service for providing best-in-class services in the area of procurement, finance/accounting, real estate management, tax planning, etc to firms desirous of outsourcing these activities.

The market is replete with examples of client firms and suppliers working towards an environment of mutual cooperation, leading to mutual gain. With outsourcing having become the focus of both academicians and industry, it is expected that the process of outsourcing would be done with more objectivity. Thus, success stories would abound, which would incentivize others to also opt for this growth strategy, thereby perpetuating the ‘virtuous cycle’ of “outsource – partner – grow”.

“YOU CAN RESIST AN INVADING ENEMY; YOU CANNOT RESIST AN IDEA WHOSE TIME HAS COME”

VICTOR HUGO