

CHAPTER TWO

BACKGROUND TO THE INITIATIVE

Outsourcing, is essentially a **how** rather than a **what** term. It describes how information technology services are obtained, namely, through the market rather than internally. In a sense outsourcing is just a new name for old practices. Services, such as bureau services, contract programming and project management have long been 'outsourced'. In its present usage, however, outsourcing implies a greater level of handing over ownership and/or managerial control than has hitherto been the case.

Dr J W. Houghton, 1992¹

Initial policy development on IT outsourcing

2.1 It is ten years since the initial phase of policy development first proposed the outsourcing of Commonwealth Government information technology. In March 1991, in a joint media statement, the Minister for Industry, Technology and Commerce and the Minister for Administrative Services set down government purchasing policy which was to be based on three key principles—value for money; open and effective competition; and support for local industry. They also issued particular requirements for the purchase of information technology (IT):

Subject to cost effectiveness, agency efficiency and public policy considerations, agencies are to test the market for outsourcing both new and existing IT service requirements, as an alternative to the maintenance of in-house capabilities. This is to be done with a view to achieving maximum outsourcing, subject to value for money and agency efficiency considerations.²

Assumptions underlying the policy to outsource IT

2.2 This move was based on the belief that outsourcing IT provides opportunities for agencies to improve the overall efficiency and effectiveness of their operations. At this time, there was a general acceptance that IT outsourcing held great potential for cost savings through economies of scale. Further, the increased capabilities of major specialised service providers would allow agencies to concentrate on core business.³

1 Dr John W. Houghton, 'Targeting IT Activities for Outsourcing', *Policy Research Paper no. 31*, Centre for International Research on Communication and Information Technologies, RMIT, October 1992, p. 4 (emphasis in original). Dr Houghton held the position of Research Associate at the Centre for International Research on Communication and Information Technologies, RMIT.

2 Joint Media Statement, 'Government Information Technology Purchasing Policy', Senators John Button and Nick Bolkus, no. 27/91, 22 March 1991.

3 See for example, 'Outsourcing of IT Moves Slowly', *Directions in Government*, December 1992, pp. 28-9.

2.3 But even at this early stage of IT outsourcing in Australia, published studies were sounding alarm bells. The first area of concern related to cost savings with a general warning that the extent of savings was still uncertain and there were hidden costs to be considered. For example Dr John Houghton in his study advised:

It is also important to remember the costs associated with managing contracts. It is necessary to retain knowledgeable people to both manage the outsourcing vendor, and to look after the needs of users within the organisation.⁴

2.4 He noted that such considerations are difficult to accommodate in costing calculations, and yet are vital in assessing predicted savings. Dr Leslie Willcocks, an internationally recognised author on IT outsourcing, strongly reinforced this point about hidden costs. He stated:

My overall feeling, from my experience of government outsourcing in the UK in the early 1990s and in the Australian case, was essentially that it was very much driven from a cost savings agenda and that was not a very good basis to do IT outsourcing.

2.5 He maintained that the cost of managing outsourcing deals is between four and eight per cent of total deal, 'and that is even before you can take into account the effectiveness of that management'. Further, he argued that informed people in consulting firms such as Deloitte & Touche were saying similar things. In referring to the early and mid 1990s, he submitted:

The information was widely available. I think the problem was that there was mixed information around at the time and one could go in several different ways...for me the weight of information fell very clearly on the side of being much more careful than some of the strategic outsourcing proponents suggested.⁵

2.6 Issues such as staff transfer, organisational disruption, an agency's loss of skilled staff and control over IT were also raised. In addition there was concern about the effect of IT outsourcing on open and effective competition in that smaller, innovative and/or start-up companies may have limited opportunities to break into a market dominated by a handful of the larger IT companies.⁶ The overriding message

4 Dr J. W. Houghton, 'Targeting IT Activities for Outsourcing', *Policy Research Paper no. 31*, Centre for International Research on Communication and Information Technologies, October 1992, p. 27.

5 Dr Leslie Willcocks, Andersen Professor of Information Management and E-Business, University of Warwick, and Associate Fellow, Templeton College, University of Oxford, told the Committee that he has conducted academic research into IT outsourcing since 1991, has written about six books on the subject and over 35 refereed papers. Committee, *Hansard*, 17 May 2001, p. 509.

6 Dr J. W. Houghton, 'Targeting IT Activities for Outsourcing', *Policy Research Paper no. 31*, Centre for International Research on Communication and Information Technologies, RMIT, October 1992, pp. 26–9. See also 'Outsourcing of IT Moves Slowly', *Directions in Government*, December 1992, pp. 28–9; 'Hurdles in Outsourcing Policy', *Directions in Government*, June 1993, pp. 22–3; Mary C. Lacity and Leslie P. Willcocks, David F. Feeny, 'IT Outsourcing: Maximise Flexibility and Control', *Harvard Business Review*, May–June 1995, pp. 84–93.

coming out at this stage was the need to look behind the assumptions about the benefits of IT outsourcing and to analyse carefully any proposal to outsource IT.

2.7 Initial policy development on IT outsourcing took place within the Department of Finance (Finance) in 1991. A Finance Circular was issued, pursuant to the Labor Government's March 1991 Industry Statement, reiterating the requirements of the Government's IT purchasing policy. This required agencies 'to test the market for the outsourcing of both new and existing IT service requirements, as an alternative to the maintenance of in-house capabilities'.⁷ As noted earlier, at this time, the policy framework relating to IT outsourcing was consistent with three criteria: value for money, agency efficiency and public policy considerations.

Information Technology Review Group Report

2.8 In 1994, the Minister for Finance directed the Information Technology Review Group (ITRG) to examine Commonwealth acquisition and use of IT. It was to consider ways of making IT a more efficient and effective means of achieving the objectives of government. In its report, *Clients First: the challenge for Government information technology*,⁸ ITRG found that the operational needs of Commonwealth agencies largely determined their IT direction. This IT environment meant that an agency had little requirement to address cross-agency developments or to take account of a whole-of-government framework embracing a more collective vision of Commonwealth needs. In brief, the report concluded that:

the fragmented policy setting for information constrains the emergence of a shared vision in the Commonwealth about the use of information technology. This contrasts with the more coordinated directions being taken by some governments overseas.⁹

2.9 Clearly, the report envisaged agencies acting within the existing devolved management framework, but consistent with an overarching whole-of-government approach 'embracing a more collective vision of Commonwealth needs'. In summary it found:

Government needs to develop and implement a roadmap for the ongoing development, deployment and management of information technology. Such a map would clearly articulate the mission of information technology, describe a vision of client service and establish an environment for execution which harnesses the potential for change.¹⁰

7 Finance Circular, 1991/23.

8 Minister for Finance's Information Technology Review Group, *Clients First: The Challenge for Government Information Technology*, Commonwealth of Australia, March 1995.

9 *ibid.*, p. 8.

10 *ibid.*, p. 23.

2.10 Certainly, this issue about the tension between central government policy and the devolution of responsibility to individual agencies to implement such policy is fundamental to the success of IT outsourcing and is a major theme explored by this report.¹¹

2.11 The ITRG report also looked specifically at IT outsourcing. It identified several issues in need of formal consideration in the event of whole-of-government IT outsourcing. These issues related to the tender process, general principles for procuring outsourcing services, sharing risks, forecasting prices, technology lock-in, loss of strategic decision-making by agencies in long-term contracts, technological change, industry development and other contractual matters.¹²

2.12 Most relevant to this Committee's inquiry is the chapter entitled 'The Outsourcing Option'. Here it was noted that most agencies agreed that outsourcing had a place and could be beneficial, but the majority argued against a whole-of-government approach. Major reservations were expressed about the ability, with a whole-of-government approach, to promote local industry growth and development. Other views expressed concerns about the potential restrictions on government's flexibility (federal and state) to 're-engineer itself' and on the 'transfer of core competencies outside agency control'.¹³

2.13 Also flagged was the potential for competition to be restricted because 'three or four large outsourcers, driven by economies of scale, would claim the lion's share of all world outsourcing'. Apart from the potential lack of choice, it was suggested that the anti-competitive nature of such consolidations—almost inevitable because suppliers to government required enormous capital and expertise—might eventually lead to disadvantage to government because of limited competition among outsourcers.¹⁴

2.14 The ITRG's review cast significant doubt on the potential for cost savings and suggested that estimates of potential savings had been optimistic. Drawing from a survey of relevant literature that had been undertaken by the Australian Information Industry Association (AIIA), the ITRG noted a marked degree of equivocation on the matter of cost savings. For example, there was evidence that in some circumstances outsourcing actually increased costs by 20 per cent or more. This figure took into account the outsourcer's margins and estimated that an outsourcer had to be 30 per cent more cost effective than existing (in-house) arrangements to cover its own costs.¹⁵

11 See for example findings of Richard Humphry discussed in chapter three, pp. 32–35.

12 Minister for Finance's Information Technology Review Group, *Clients First: The Challenge for Government Information Technology*, Commonwealth of Australia, March 1995, pp. 62-3.

13 *ibid.*, p. 57.

14 *ibid.*, p. 61

15 *ibid.*, p. 59.

2.15 The report further suggested that realising cost savings was dependent upon a number of factors including, but not exclusively confined to, economies of scale. Cost savings were dependent on real reductions in the costs of physical support (for IT systems). It was observed that cost over-runs were frequent ‘because the scope of functions or unexpected developments [or requirements] were not specified in contracts’. Over the longer term, out-of-contract payments were often required to maintain or upgrade IT service levels.¹⁶

2.16 The ITRG report clearly identified issues of significance that needed to be considered in the event of the Commonwealth embracing a whole-of-government approach to IT outsourcing. As such, valuable pointers were now available to government.

ANAO Report No. 21 1996-97: Department of Veterans’ Affairs

2.17 In 1992, the Department of Veterans’ Affairs (DVA) was the first Commonwealth agency to outsource its data centre. In 1996 the Auditor-General conducted a performance audit that sought to ‘identify the extent to which DVA achieved its objects of outsourcing and the effectiveness of its management of the arrangement with the supplier’ from February 1992.¹⁷ The Auditor-General’s report flagged some crucial issues. It made three recommendations relevant to future IT sourcing arrangements. It recommended that DVA:

- Give priority to conducting an evaluation of the achievement of expected outcomes early in the life of the next outsourcing arrangement.
- Document the management arrangements for the next outsourcing contract and communicate this to relevant staff. Such documentation should include the allocation of responsibilities between DVA and the supplier, the management structure within DVA and operational procedures including any undertaken jointly with the supplier.
- Ensure that in the preparation of the contract for the next outsourcing arrangement the documents reflect developments in the outsourcing industry and the outsourcing experience gained by the Department.

2.18 These recommendations were specific to one agency but were highly prescient for future development of whole-of-government policy on IT outsourcing. Particular lessons arising during the outsourcing process as a whole, from tender stage

16 *ibid.*,

17 ANAO, *Management of IT Outsourcing - Department of Veterans’ Affairs*, Audit Report No. 21 1996-97, p. 3.

to post-contract management, were identified by the Australian National Audit Office.¹⁸

18 As a result of this performance audit, ANAO flagged their intention to produce a better practice guide on the management of IT outsourcing contracts for the Australian Public Sector. The ANAO's *Contract Management: Better Practice Guide* was released in February 2001.