Outsourcing Complex Business Processes: Lessons from an Enterprise Partnership

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Outsourcing initiatives are key to firm efforts to focus on core competencies, alter engrained practices and attain significant cost reductions in non-core processes. Extensive thought goes into the selection of outsourcing service providers, with the aim of enlisting vendors that have the competence and reputation to lower cost and enhance service levels. However, in addition to traditional fee-for-service outsourcing, another option is to develop a new enterprise that is wholly or partially owned by the outsourcing entity to take on the activities that are externalized —a so-called "enterprise partnership." This article examines one of the first examples of such a partnership: BAE Systems' efforts to outsource its HR services in collaboration with Xchanging. It tracks the evolution of the resulting enterprise partnership from the perspective of both the new vendor and the outsourcing firm. The article also discusses the need for explicit contractual recognition of key phases of the outsourcing life cycle as a means to reduce inevitable in-process conflict. Understanding the divergence of interests that naturally emerge is critical to realizing the long-term promise that enterprise partnerships offer. (Keywords: Outsourcing, Inter-firm Relations, Enterprise Partnership)

Outsourcing can be a catalyst for quick change and cost reductions. Likewise, the outsourcing of back-office processes, such as payroll processing or indirect procurement, promises to lower cost and raise the service level. This sector has undergone tremendous growth in the past decade, with global revenues in excess of $200 billion globally and an anticipated growth rate of 10% per year.[1] In traditional business process outsourcing (BPO), a supplier owns and operates the infrastructure, applications, and people required to deliver services to a customer organization—in many cases, an organization from which they have been transferred. The firm pays a fee for a service, which generally involves transferring assets and staff to the company providing the outsourcing. This fee-for-service structure works

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well for highly repetitive and standardized processes such as payroll or loan application processing. It does not fit well with processes that are complex, customized, or infrequent, such as recruitment, benefit advice, or management development. Past experience shows that in such cases the risk of failure can be considerable.[2] The complexity of the processes often requires wordy legal and contractual arrangements that must be negotiated before commencement—a time-consuming process that can delay the launch of a venture by a year or more.

An enterprise partnership provides an alternative model to traditional BPO and may be particularly helpful to firms outsourcing more extensive processes and services. In this article, we examine the development of an enterprise partnership between BAE Systems and Xchanging. Such a partnership provides a useful option to firms considering outsourcing complex processes. The enterprise partnership is a finite venture, and has distinct phases. We illustrate the key phases an enterprise partnership goes through and discuss the distinct challenges each presents over time.[3] With an understanding of these phases, together with several proactive steps to mitigate resulting challenges, enterprise partnerships provide a real alternative for executives considering outsourcing complex processes.

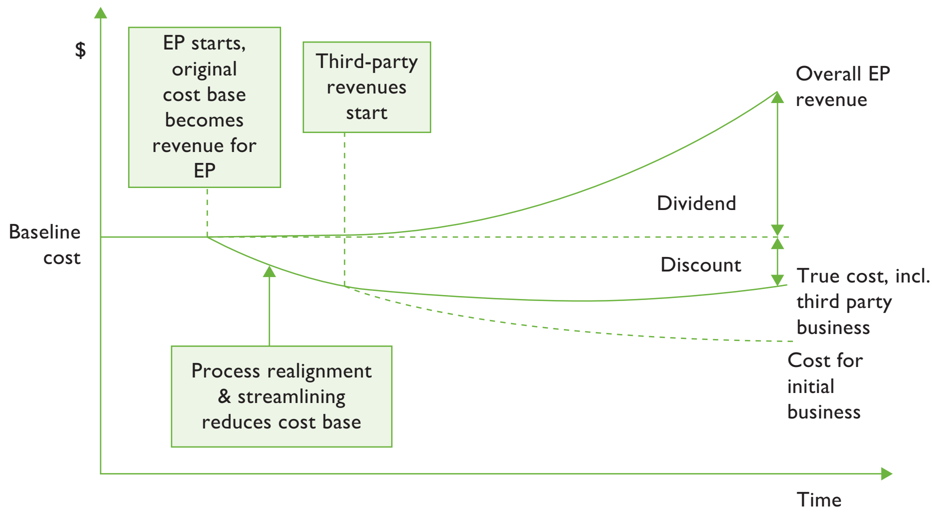
Enterprise Partnerships: A Departure from Traditional Outsourcing

In a traditional outsourcing arrangement, the outsourcing firm finds a vendor that provides the outsourced services on a contract basis. In an enterprise partnership, a joint venture or equity-based relationship is established to provide the outsourced services. As its name implies, an enterprise partnership aims to bond partners, creating a jointly owned entity that both partners must nurture for mutual benefit. With this shared interest, the need for protection against opportunistic behavior is less of an issue. Parties are less likely to need lengthy negotiations and the work is outsourced quickly. With no need to detail each task, its output, and its associated fee, outsourcing can cover a wider range of services and processes. Recruitment is a good example: In traditional BPO, outsourcing the recruitment must be done case by case, since requirements will change according to seniority and so on. This makes it difficult to arrive at a standard fee for the entire service. In an enterprise partnership, the recruitment can form part of the service portfolio without the need for such a high degree of specification.

Perhaps the most telling difference is how the financial rewards are structured. Traditional outsourcing is considered a success if costs go down by 20–40 percent compared to baseline cost. These savings result in pre-defined levels of reductions in fees for the respective services contracted.

In an enterprise partnership the financial model is different (see Exhibit 1). On "day one," the existing cost base becomes the revenue for the shared entity. The

EXHIBIT 1. The Financial Model of an Enterprise Partnership



same cost savings as in traditional outsourcing are also achieved in the early phase of an enterprise partnership and are paid out as a "discount" on the baseline cost. In addition, the joint entity seeks third-party revenues by offering its services to outside customers, thereby leveraging assets such as IT platforms to generate better economies of scale. The additional revenues are shared as "dividends" between client and vendor.[4] Although the overall cost base will rise for the shared entity, both parties profit from the increased revenue and economies of scale that are generated. After three to five years, when the partnership converts to a traditional outsourcing model, the client gains capital upside from the sale of its ownership in the shared entity company. This financial model embodies the two core concepts of the enterprise partnership: providing a mechanism for creating shared interests; and providing an equal sharing of risk and profit. This setup creates a very different organizational structure along with a different set of incentives and governance structures compared to traditional outsourcing (see Table 1 for an overview).

Retrospective on an Enterprise Partnership

BAE Systems is a $35 billion-a-year company that specializes in defense, security, and aerospace. It is the outgrowth of a 1999 merger between British Aerospace and Marconi, in which executives promised $550 million in merger-related annual cost savings within 3 years. This target cascaded to all business areas as a 15 percent cost-reduction mandate. For Human Resources (HR), that meant achieving a $7.5 million cost reduction on an annual HR expenditure of $50 million. Because BAE Systems had a history of mergers and acquisitions, HR was already highly fragmented: 680 HR professionals across 70 sites worldwide were managing their own HR workload, relying on 27 different IT systems

TABLE 1. How Traditional Outsourcing Differs from Enterprise Partnership

Characteristics	Traditional Outsourcing	Enterprise Partnership
Strategy	Focus solely on cost reduction	Focus on business processes and the realities of profit and loss
What Outsourcing Provides	Individual transactions, technology platform, and domain-specific knowledge	Process improvement through lean six sigma projects and use of IT platform
Ownership of Assets	Assets in terms of trained employees, software and hardware are given away	Joint ownership from the start
Source of Cost Savings	Operational improvement, headcount reduction, and economies of scale	Traditional outsourcing sources, plus the leveraging of third-party business assets to generate economies of scale
Key Concerns and Risks	Service price variations and major technology expenditures	Profit sharing
Schedule	Typically 1-5 years contract length, start-up times from 6 to 18 months	10-year service agreement, with the option to buy out at given checkpoints (5 and 7 years); start-up within 6 months
Main Drivers	Technology	Operations and service, aided by technology
Governance	Committees, but with no legal requirements to attend	Board of directors and service and technology review boards, which engage client and vendor in a continued relationship
Control and Trust	Partners perceive or experience loss of control over their institutional knowledge and destiny; trust is limited on either side	Partners retain control through a management board and have veto rights; actions are fully transparent
Operational Objectives	Focus is on immediate, but short-term cost reduction	Focus is on continuous improvement over the long term

and 12 paper systems to conduct payroll, benefits, recruiting, training, and HR procurement for over 250,000 employees and their dependents. Consequently, the HR function covered a broad service spectrum—from purely transactional payroll and benefits processing to highly customized recruiting, training, career development, and advisory services. The company's history of mergers and persistent underinvestment had left HR with neither a common global IT system nor streamlined standardized processes. To centralize and downsize its HR units, BAE Systems was looking at a possible major investment compounded by the limited central control of HR services and turf wars among local managers.

HR decision makers began examining several options: One was to have BAE Systems try to "go it alone." However, this seemed unrealistic in light of the planned reductions, which called for drastic change and major IT investments. Although consultants could have helped with the process reengineering, BAE Systems was not prepared to devote significant management attention to such a large internal project given the more pressing need to integrate Marconi.

Another option was to outsource the transactional HR processes while retaining the more customized services in-house—essentially following the well-trodden path of conventional outsourcing. However, partly influenced by poor experiences with this model in the past,[5] management felt that this solution would not yield the needed cost savings and would have split the HR organization roughly in half.

The last option was to develop a partnership with an outsourcing firm—an opportunity offered by David Andrews of Xchanging. Armed with a handful of service, process improvement, and functional specialists, Andrews had launched Xchanging, a business process services organization whose business model was based on creating *enterprise partnerships*. In these arrangements, the client and vendor jointly develop a third company. To BAE, a partnership model had compelling benefits. BAE could transfer the majority of its HR staff to a new jointly owned entity with Xchanging, and it could achieve the needed operational savings and IT investment. In February 2001, after a year of intense negotiations and even a late competitive tender, BAE Systems decided to become Xchanging's first customer. They jointly established the Xchanging HR Services (XHRS) enterprise partnership.[6]

Anticipating the Evolution of an Enterprise Partnership

In exploring the evolving nature of exchange between partners, we found four distinct phases that occur in enterprise partnerships (see Table 2). In the *realignment* phase, processes are redesigned and both parties collaborate to attain and enjoy initial cost savings. In the *streamlining* phase, processes become standardized and further improvements come at the expense of one of the two parties. Adversarial postures emerge as mutual incentives disappear. Providing such distinct labeling of the two initial phases was a deliberate step by Xchanging in order to emphasize radical and incremental improvement at the respective stages.[7] The subsequent stages were not specifically labeled by Xchanging; we provide their labels based on what we perceive their main purpose to be.

During the *scale* phase, the outsourcing provider will seek third-party revenues to create further scale. This often requires investment needs that are not in the interest of the client, creating tension between the two parties. Finally, the *maturity* phase marks a complete service commoditization that is manageable on a traditional arm's-length fee-for-service basis. At this point, the misalignment of interests is pronounced enough to motivate the client to shop around for the best commercial option.

It is crucial to understand how the expectations of both parties change over time as the outsourcing venture progresses. Consciously mapping these allows both parties to tackle the challenges that will emanate from diverging expectations and commercial pressures. While the existing studies on outsourcing have shown similar life-cycle effects,[8] our case study illustrates the importance of both parties considering and managing these stages. There are distinct activities underlying these stages, and terminology may change across firms. The starting point is a radical re-engineering to create a new process. This is followed by a phase where the radical improvements are replaced with continuous improvement of this new process. Conjointly, these two phases deliver the initial cost savings; and the potential for further cost savings from process improvements is then largely exhausted. The focus then turns to generating economies of scale, either by

TABLE 2. The Four Stages of Enterprise Partnerships

Stage	Activities	Challenges	Savings Achieved via . . .
1. Realignment	▪ Transfer staff ▪ Transfer and streamline technologies ▪ Absorb resources into outsourcing enterprise ▪ Attrition ▪ Shift to customer-focus	▪ Hidden activities and costs ▪ Possibly inadequate existing infrastructure	▪ Cost reductions ▪ Headcount reduction ▪ Aligned purposes ▪ Consolidation of activities
2. Streamlining	▪ Improve processes through standardization, routinization, and use of lean and six sigma methods ▪ Deepen understanding of service purpose	▪ Interface rigidities ▪ Service-level agreement boundaries hem in and create inherent tensions ▪ Agreements center on identifiable transactions rather than identifiable goals	▪ Standardized, streamlined processes ▪ Reduced demand as processes improve at customer and service provider
3. Scale	▪ Leverage economies of scale, either by integrating other clients, or by seeking third-party revenue (needed most likely for smaller BPO providers)	▪ Slack resources create pressures to find new business ▪ Discontinuities in scale ▪ Investment needs to continue state of the art	▪ Increased cost base reduces service fee due to economies of scale
4. Maturity	▪ Sell stakes ▪ Renegotiate contract, seek best commercial offer	▪ Commoditized process ▪ Standardized interfaces to enable transfer	▪ Open market competition among providers

leveraging in-house assets and synergy between existing clients, or as in this case, by securing third-party business. Finally, and perhaps the hardest to recognize, is the maturity phase where the process has been completely commoditized. At this point, the client firm can seek "fee-for-service" offers in the open market without repercussions.

Stage 1: Realignment

This first stage, typically lasting several months to a year, is primarily to prepare the staff for the venture ahead and to reach agreement on the commercial terms. The entity that will eventually become a jointly owned company or outsourced activity is still an internal cost center at this point.

The first phase is marked by the congruence of objectives between the client and outsourcing firm. Both sides have distinct yet complementary objectives, and the main work in this phase is to align those. BAE Systems wanted a streamlined

HR service with quality consistent or better than that offered by existing processes, but at a considerably lower cost. It recognized that investment in a new IT system was also crucial. For its part, Xchanging wanted to create a true partnership that allowed it to reengineer processes quickly, with the full support of BAE Systems, and to start up operations rapidly.

Despite initial misgivings, the enterprise partnership prevailed—largely because BAE Systems felt the risk was minimal given the flexibility that the model offered. BAE could retain more control over HR services than it could with traditional outsourcing. Even if additional revenues did not materialize, BAE could benefit from the operational savings typically achieved in outsourcing non-core processes. Perhaps most importantly, it could obtain the much-needed investment in a new IT infrastructure.

In the end, the two parties reached three agreements:

- a 10-year service agreement identifying services to be delivered, standards, and governance;
- an operating agreement detailing how the required client resources were to be provided; and
- a shareholder agreement stating how the partners will own the business and share benefits.

The outsourcing arrangements were worth over $500 million, and XHRS was set up as a 50-50 joint ownership.

After learning that the enterprise partnership was to take place, eligible staff members were identified and transferred into the enterprise partnership. Some personnel wanted to remain with BAE Systems and applied for jobs within the company. Others were happy about their new role in a more commercial environment. Those open to change found it refreshing to view their services as having commercial value and generating profits, rather than being merely part of a back-office process that represented overhead cost.

The transition occurred with little disruption because the same people involved in the day-to-day business were still doing what they had always done. The key departure from "business as usual" was that Xchanging put well-trained process specialists behind the scenes to ask questions in a methodical way and used the answers to make processes more efficient, to remove redundant process steps, and to eliminate rework. All process steps were mapped, measured, and scrutinized; hand-offs were questioned; and responsibilities were reassigned.

Challenges

This stage was difficult for both parties. Many in BAE Systems felt that an enterprise partnership was too risky. Some believed that too much control was being handed to a third party; others felt that this new model was too untested to be applied on such a large scale. The determination of the appropriate boundary is a complex question and one that often is approached with trepidation.[9] The HR staff was bewildered at the changes and more than a little suspicious. Many began questioning what the venture meant for BAE Systems. Up to this point, BAE Systems had followed a traditional model with its outsourcing suppliers (such as outsourcing its IT to a third party), and the staff felt that this arrangement had been successful enough. There is ample evidence that business process outsourcing can lead to a loss of control and a knowledge mismatch between the partners.[10] The former was particularly problematic at BAE, and the HR executives felt that retaining the established corporate boundaries would also ensure continued control over key systems.

BAE Systems management at many sites left it to Xchanging to convince people of the need to use XHRS—a task that was a huge drain on Xchanging's resources. Several countries in the BAE Systems world—some powerful, some just remote—refused outright to hand over control of their HR operations. This reduced the scope of the effort to the UK operations plus support for global management. Close to signing the deal, internal concerns continued to influence the decision, with BAE Systems even inviting competing bids late into the negotiations to ensure the conditions were competitive. This came as a surprise to Xchanging, which thought negotiations were reaching completion.

Another challenge was getting BAE's internal customers to recognize the higher service level. In this first phase, measuring any service has both a hard, or empirical, side (such as lead times, error rates, and so on) as well as a soft, or qualitative, side that reflects individual perceptions. Perceptual measures tend to lag three to four months, even if hard measures show improvement. Thus, simply measuring hard evidence about a service was not enough to gauge how customers in BAE Systems felt. For example, although empirically the payroll service that XHRS was providing showed fewer errors on pay slips than before, the BAE "customers" perceived no improvement in this new service, and actually gave it worse ratings than before. Undertaking comprehensive customer surveys provides valuable insights into "pressure points" to be addressed.

Other common teething pains in this phase relate to hidden activities and unanticipated costs. XHRS was not exempt from these. For example, data challenges led to a 10% failure rate for the first sets of paychecks issued through the new IT system. A data cleansing team was established to ensure that all records from BAE Systems were checked and corrected when needed.

Consolidating and automating processes can lead to their own problems, which underlines the importance of having all key enablers in place for the system to work. In the case of XHRS, a new e-HR system was successfully rolled out. However, it received poor feedback from some users because the BAE IT network over which it was delivered was too slow. XHRS was not at fault, yet from the customers' vantage point, this made no difference.

Outcomes

BPO introduces efforts to measure core outcomes in ways that may not have been the case when the same activities are undertaken within the firm. This leads to both a better understanding of customer needs and an opportunity to assess process effectiveness. Process realignment (or process re-engineering) and customer orientation give rise to questions about the process: what does the customer need and value, and what is the most efficient way of providing this service? All process steps are then mapped and scrutinized, hand-offs are questioned, and responsibilities are reassigned. Typically, as new technologies are introduced, operational improvements are identified, practices and policies are consolidated, and significant efficiencies materialize. XHRS was no exception. As a result of these efforts, BAE was able to significantly rationalize its resources, consolidating 37 of its HR locations into five and merging 23 IT systems into one.

A key outcome of the realignment phase was the *absorption* of staff: XHRS transferred and retrained 430 former BAE Systems staff. As locations were consolidated and technology was introduced to standardize processes, the *attrition* of extraneous personnel led to considerable cost savings. Equally important was the process of consolidating common functions and folding processes into a routine. XHRS identified some 400 individual service items making up the service to be delivered, together with 12 overarching service measures.

Stage 2: Streamlining

The second phase centers on steps to further process improvement. The realignment phase reengineers the structural elements of a process. The streamlining phase hones the procedures and routines and continuously refines them.

Process variation is eliminated through standardization and routinization. In the case of XHRS, Xchanging brought in its service and Six Sigma process improvement experts and technology specialists. They helped communicate the service objectives and realign existing processes to meet customer needs and efficiency targets. They also streamlined and ironed out process problems by applying focused lean six sigma techniques and instituted a procedure for promoting continuous improvement. However, at this stage in the life cycle it is not just about streamlining and cost reductions; the provider leverages its unique competence to innovate in ways that are not necessarily contractually specified and that extend beyond traditional process rationalization.[11] In the case of Xchanging, the firm shifted a substantive amount of its HR services to a web-enabled platform, investing $20 million to enhance its technological capacities at XHRS.

The agreement guaranteed baseline target savings: a 10 percent cost reduction in the first year and a further 5 percent in the second year. The cost reduction was to be delivered as an up-front rebate on transaction price, partly because of fiscal considerations. That is, if $50 million costs were transferred in 2001, XHRS would charge BAE Systems only $45 million in the first year, and $43.7 million from the second year on, for the services contracted.[12] The agreement also specified that any profits from further cost reduction and additional third-party profits (such as selling XHRS services to third parties) would be split 50-50. Although the last specification is unique to XHRS, the general pattern of guaranteed cost reductions, with provisions for dividing additional savings, are typical of this stage. In addition to efficiency considerations, this stage is characterized by efforts to standardize and improve quality. BAE Systems' BPO agreement also included service guarantees indicating its performance would be in the upper quartile of industry benchmarking of service levels by the end of 2005.

Challenges

Because at this stage the two parties are in a streamlining mode, rigidities will emerge at the interfaces, rendering holistic process improvement difficult. The process has been transferred to the outsourcing party, and the customer that undertook the BPO has little incentive to cooperate. In a typical BPO arrangement, service-level agreements can run from 1,400 to 2,000 pages with extensive specifications on all details. This makes it difficult for the BPO provider to leverage opportunities or address challenges that emerge in any dynamic environment at the interface between the BPO provider and the client firm.

Service-level agreements center on identifiable transactions rather than underlying goals. Consequently, process improvements soon hit the boundaries of the service level agreement, leading to tension and disagreements. In the case of an enterprise partnership, the joint ownership creates some alignment of interest but some disagreements still emerge at this stage. For example, although XHRS offered centralized HR services, some HR functions remained with BAE Systems' management at the respective sites to provide local support. The individual HR sites did not share in the savings that the centralized arrangement enabled, but faced the same ratcheting of service expectations that took place at XHRS. As a result, once Xchanging redefined the service level, these residual HR functions within BAE were also doing more work, leading to friction. Further, Peopleportal was supposed to offload tasks from the organization, but it met with resistance from those used to doing things the old way. As a multinational defense firm, BAE Systems employs a range of employees from rocket scientists to shipyards welders. Thus, the avionics employees in Edinburgh were quite pleased with efficient HR services delivered to their desks through their PC. However, the workers at the naval shipyards in Govan and Scotstoun in Scotland had no desks and no PCs, which led to significant grumbling. To appease these employees, XHRS had to set up public terminals and provide face-to-face services at specified times.

Outcomes

In this second phase, costs continue to go down. Initial cost savings attained in the first stage are further enhanced as the focus shifts from consolidating and routinizing to systematically improving operations through the use of Lean, Six Sigma, and other process improvement methods, as well as through headcount reductions.

In the combined alignment and streamlining phases, cost reductions of 20 to 40 percent can be expected when traditional process control and improvement techniques are put into play. In the case of XHRS, cost reductions of 32% were attained in relation to "day 1" costs within the first two years. About 25% of these savings stemmed from better use of technology, including automating processes and procedures, migrating services to a common hosting model, and rigorous project management. Just over 20% of the savings stemmed from better sourcing, including aggregating volume and compliance to preferred deals. Service and process improvements accounted for another 33% of the savings. With respect to service, an internally focused back-office function was transformed into a customer service entity with standardized service descriptions and associated performance measurement. Employees were engaged in improving services and products, and systematic efforts were made to eliminate non- value-added services using Six Sigma techniques. To support process improvements, XHRS trained 23 people as Six Sigma green and black belts. It further added 19 full-time technologists and process specialists to its staff to standardize and improve its approach to HR delivery. The remaining savings, a little over 20%, stemmed from a number of different initiatives, including right-sizing office space, rigorous project management tools, and skills-based training of employees. Over the six years of the enterprise partnership, these efforts saved BAE Systems over $40 million.

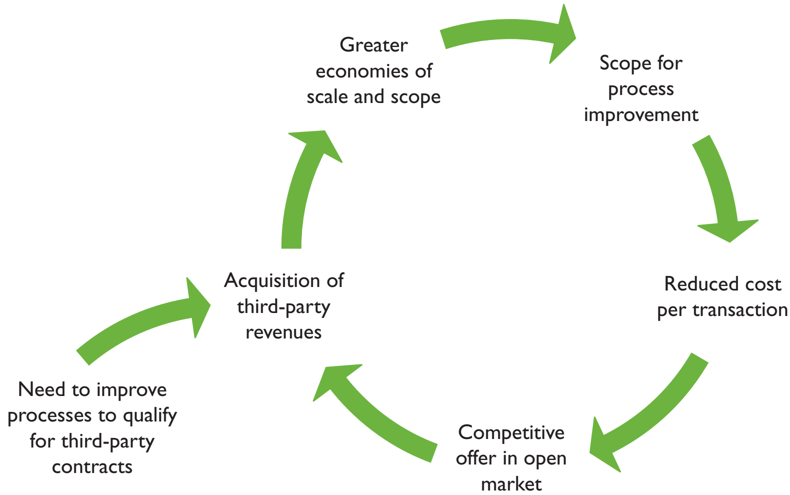
Stage 3: The Quest for Scale

At this stage the process, improvement potential is exhausted: the processes are honed and often additional resources have been freed up (both labor and IT system time). At this stage, pressure mounts to redeploy these resources productively. The goal is to put the efficiencies gained to good use by offering the capacity freed up in the service platform to third parties. For a large outsourcing provider, it would be easy to integrate processes on common technology platforms and derive economies of scale in-house. For Xchanging, with BAE Systems as its first client, generating third-party revenue was essential to build the commercial basis of the enterprise partnership. In the case of an enterprise partnership, the partnership must develop its capabilities and improve its processes to such a level that it can compete in an open market. This competitiveness directly benefits the client by providing a better HR service and indirectly adds revenues for the client. As it expands, the BPO provider commands additional economies of scale that further reduce cost and improve competitiveness. We refer to this as the virtuous cycle of enterprise partnerships (see Exhibit 2).

Without this opportunity to leverage scale in both the technology platform and associated processes, the investment in improvements represents an effective increase to the cost base. Because the ongoing process improvement will free up resources—both labor and processing capacity—acquiring new business is the primary avenue to translate that capacity into actual profits. An alternative is laying off people to extract the benefits of efficiency improvements. However, this option is not ideal because it demoralizes the remaining staff, is costly, and hampers future process improvements since employees have no desire to rationalize themselves out of a job.

While the goal of increasing the outsourcing firm's activities is clear, there generally is little scope to increase business within the customer's organization. The outsourcing firm must therefore look toward acquiring third-party business.

EXHIBIT 2. The Virtuous Circle of Third-Party Revenues



By leveraging labor and IT systems for third-party firms, along with the pressures of competing on the open market, the BPO provider can offer further cost reductions for the original client firm.

Challenges

To service additional clients, the outsourcing firm must optimally manage discontinuity in scale in the underlying technologies and personnel choices and it may also need to invest to stay ahead of the innovation curve. Managing the impact of this third-party business can be tricky. In the case of an enterprise partnership, the client that sought outsourcing in the first place is involved in a growing company whose primary business is in a different market. It is thus drifting farther from the client's core business as third-party contracts are added. The partners must agree up front on boundaries for shared interests. If, for example, Xchanging wanted to diversify, that action would have to take place inside Xchanging, not XHRS. This would require that BAE Systems invest in such a decision. At BAE Systems, we noted some discomfort in being both a shareholder of XHRS and its principal customer. In particular, executives expressed concern about the risk of investing outside BAE's core business as XHRS expanded its external offerings. For example, if a new customer for XHRS required a $10 million investment in hardware and software, BAE Systems would effectively be spending $5 million on HR systems for a third party. Getting pulled so far from a company's core business is not a logical move, particularly since the initial goal was to outsource services perceived to be non-core. This creates tension between the client who is not willing to support any further investments needed to service third parties and the outsourcing provider who sees benefit in expanding the customer base of the jointly owned venture.

Stage 4: Maturity

In this final stage, the outsourced process has been commoditized and the interface with the rest of the organization has been standardized. The client firm is at peace with the fact that the outsourced unit is no longer part of its organization. The client firm's internal customers are comfortable with the outsourced model, and the ex-employees no longer have any potential impact on morale at the client organization. It is time for a shift to a transactional and arm's-length model of exchange. The standardized interfaces and accepted protocols mean that the service is more easily specified and transitioning to an alternate provider is a potential option. For non-commoditized services, this maturity phase may present different challenges.[13]

It is not easy to recognize this stage, as there is no stage gate in place that would allow us to measure when the process had been converted into a commoditized service. All parties involved confirmed to us, with hindsight, that planning for a finite end date would have been beneficial in order to force a review of whether or not it was time to conclude the enterprise partnership.

Challenges

At this stage, the competence required for the outsourced activities are now fully externalized. This precludes the option of returning activities in house.[14] However, sufficient know-how needs to be retained to ensure the ability to transfer to other providers if needed. The main activities at this stage are to completely externalize the entity handling outsourced activities, and to retender for a new or better deal with the existing provider or potentially other providers. With an enterprise model the outsourcing organization needs to recognize that the ownership tie to the entity undertaking the outsourced activities is no longer generating value directly from its outsourced activities. This creates a tension that is best resolved via a sale of the outsourcing entity's ownership stake. If both routine and complex activities were outsourced, it is important to ensure that different systems are established for each.

Outcomes

BAE Systems and Xchanging entered this stage in February 2007. The next month, BAE Systems sold its 50 percent share of XHRS to Xchanging, which assumed full control of XHRS. This essentially rendered XHRS a traditional outsourcing provider to BAE Systems. To prepare for the buyout, BAE Systems and Xchanging met to redefine the service-level agreement for the future operation of XHRS as an independent service provider to BAE Systems. This revision involved new and more rigorous service definitions and performance metrics as well as a mechanism for transaction pricing. This helped reassure BAE Systems that, even under the new ownership situation, the quality of service would be maintained. These revisions are consistent with traditional outsourcing arrangements. At the same time, BAE also revisited the outsourcing of the most complex component of the HR function—the recruiting of senior executives—and sourced it under a new contract.

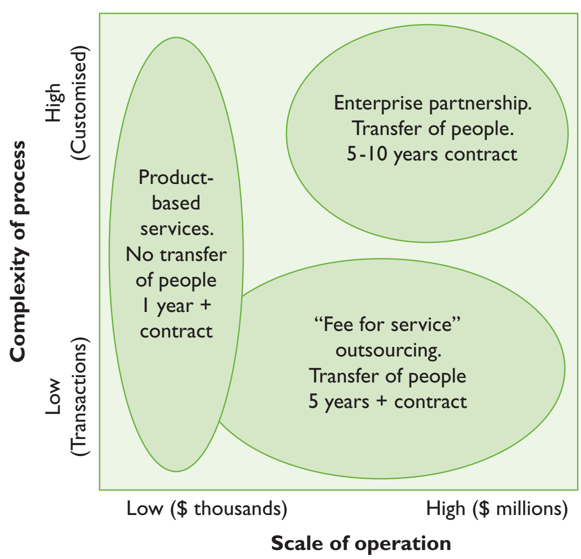
In an enterprise partnership, the relationship continues, even with the sale of the client's equity stake; it simply evolves into a more traditional outsourcing model. In fact, as BAE Systems and Xchanging were completing the sale of XHRS, BAE Systems extended its 10-year service agreement by another two years until 2013. At that point, XHRS may well compete like any other outsourcing service provider for BAE Systems' business, but it will do so with the advantage of more than a decade of collaboration with BAE Systems. So, although the ownership of the shared company shifts to the outsourcing provider, the operations continue as before. Although the vehicle for delivering the outsourced services changes, the relationship that has built up between the parties remains.

When to Choose an Enterprise Partnership

Firms often choose the enterprise partnership model because of its ability to deal with complexity *and* scale, which other models cannot provide (see Exhibit 3). It is a good choice if the firm is mature enough to recognize the need to improve back-office functions, has a sufficiently large operational scale, and has complex processes that do not fit well with a fee-for-service structure. For an enterprise partnership to work, the firm seeking a provider does not have to be able to define the service to be outsourced in as much detail as it would in a traditional outsourcing deal. However, the service operation must be relatively stable in scope and scale. This is generally only possible with a mature business line.

An enterprise partnership's structure is another reason that scale is crucial. Each partnership is essentially run as an independent business with all associated costs—board of directors, registrations and filings, and so on. This implies the need for a cost base on the order of more than $100 million per year, and units with several hundred to several thousand employees. Scale also figures in the benefit of adding third-party revenues. A firm must be large enough to aggregate other business profitably.

EXHIBIT 3. When to Use an Enterprise Partnership



Finally, an enterprise partnership works best in complex settings with diverse processes that are important to the client and that depend on specific process or technology expertise. These can later be used as a platform to offer the services to third parties in the open market.

Planning an Enterprise Partnership

As this case illustrates, it is critical to understand the phases the enterprise partnership will go through and plan for both the challenges and opportunities that each stage presents. Contractually, and operationally, it is important to recognize the limited life span of the contractual arrangements and to anticipate the conflicts of interest and misalignment of incentives that will emerge. Understanding and leveraging the life cycle of the enterprise partnership helps firms stay ahead of the frustration curve and reap the benefits that come with each project stage. There are a range of factors that will contribute to the successful outcome of an enterprise partnership. For example, it is important to have a dedicated senior staff member at the client firm to manage the interface with the outsourcing provider. Also, having regular performance review meetings (in this case capturing both "hard" metrics as well as "soft" perceptions of the services provided) are crucial. There are two other specific steps that are essential in considering an enterprise partnership: dealing with slack resources; and building in a finite end date.

Specify how the parties will deal with slack resources

As processes improve in the second (streamlining) stage, slack resources will emerge from understanding cost and revisiting cost drivers. When those slack resources are found in the outsourcing firm, they can be addressed through attrition and re-deployment. This requires a constant re-evaluation of resources devoted to the outsourced activity by the outsourcing firm. Having a key executive who is fully responsible for the arrangement, and who is rewarded accordingly, is critical. Target goals should include not just whether the agreement is meeting quantifiable criteria such as cost reductions and headcount reductions, but also a systematic evaluation of how less tangible or less easily identifiable resources within the outsourcing firm are used and re-deployed.

In the case of an enterprise partnership, slack resources that emerge under the control of the jointly owned partner cannot be addressed through attrition as easily as in the alignment stage when the outsourced entity was set up. Since no more business is to be gained from the original client, the obvious option is to seek third-party revenues in the open market. This move, however, elicits further tension between the original client and service provider because the original client is not likely to be interested in altering processes or investing capital to acquire such third-party business. The client that sought outsourcing in the first place is involved in a growing company that is drifting farther from the client's core business with each third-party contract.

The partners must agree up front on boundaries for shared interests. It is generally not feasible to omit the pursuit of third-party revenues, since doing so deprives the service provider of considerable improvement potential through shared technology platforms and scale economies. The point is to make these conflicts clear from the outset and to set the boundaries for any third-party expansion.

Build in a finite end date

A misalignment in incentives and interests will develop *naturally* between client and service provider, so it is critical to establish an end date, and to periodically re-evaluate that date. At Stage 4, when the work is sufficiently standardized and the interfaces with the vendor are accepted and well understood, the relationship is ready for re-evaluation. This may include exploring the pricing of other vendors, as well as other activities that can be outsourced through the same interfaces. A challenge in this process is predicting up front when this point will be reached. A sunset clause forces this evaluation. However, an annual or even bi-annual renewal clause may be even more desirable. This provides both parties with the incentive to sit down and re-evaluate the progress attained, and develop plans for the coming year. This is particularly important in traditional outsourcing models where no ownership stakes are involved. However, even in the case of enterprise partnerships where both parties extract profit from the relationship, the misalignments emerge. BAE Systems decided to pull out four years earlier than the original contract termination date because the company was starting to feel uncomfortably close to the outsourcing business. Continuing ownership in the joint entity for too long can be damaging. BAE's core focus is the aerospace and defense business, and ultimately, its involvement in XHRS distracts from its core activities. Looking back, both BAE and Xchanging believe the optimum time to remain in an enterprise partnership is less than the six years they had such an arrangement. It should be enough time for the client to attain value from the shared ownership, to build up confidence, and to ready them for the terms and conditions of the more traditional arm's-length third-party arrangement that follows.

Having a fixed partnership period in everyone's mind from the start gives an edge to the relationship and makes the post-partnership transition much easier. As Andrews of Xchanging put it: "The productivity improvements generate some savings that you can share, and some service improvements that you can measure. That satisfies people for three years or so. After that, people want to renegotiate." Andrews acknowledges that the third-party revenues made possible with an enterprise partnership take both parties forward, but only for a few years. Then the client reaches a point where it does not make sense to have ownership in a growing HR and a procurement business that is not part of its core operations.

The importance of ending the joint ownership of the enterprise partnership earlier rather than later was shared by the outsourcing firm: Alastair Imrie, Group Director for HR at BAE, felt that, with 20-20 hindsight, even in their collaborative arrangement a faster transition through the life cycle would have been preferable: "You've got to have a clear intention in your mind's eye as to when you are going to switch to the true arm's-length relationship. . . . Looking back, I'd have to say that period should be 3 to 5 years."

BAE Systems and Xchanging had periodically discussed a potential end to the enterprise partnership. At the time of the sale, both agreed that this was indeed the right moment to change the arrangements and to enable BAE Systems to extract the capital value from its ownership interests. No adversarial emotions arose. Even so, it is not always easy to discern the proper time to end such an arrangement. As noted, the expansion to include third-party revenue creates misalignment in stage three (the quest for scale). It is important to plan periodic revisiting of the ownership arrangement, starting a few years after the partnership is set up. This allows the collaboration between the two parties to segue gracefully into alignment once again through a proactively and amicably arranged sale or spinoff before tensions escalate.

The Mutual Pay-Off

Outsourcing projects generally promise great financial savings in non-core parts of the business, which is an attractive proposition. Managed correctly, enterprise partnerships can deliver substantive additional returns. For BAE Systems and Xchanging, their jointly owned company delivered value far beyond the operational cost savings of traditional BPO. Over the six years it shared XHRS, BAE saved over $40 million in operational savings associated with improving the HR processes. It made another $40 million in the form of profit dividends from its part-ownership in the jointly established partnership. However, the real returns came when it sold its share of XHRS back to Xchanging for $100 million and moved to a traditional fee-for-service model in 2007.

Xchanging similarly benefited from the revenue that XHRS generated and from BAE Systems' support of process improvements in the jointly owned company. When it entered into partnership with BAE Systems, Xchanging had 28 employees. It now has over 4,700. Of these, XHRS, the outcome of its joint efforts with BAE, employs 490 people. In addition to BAE Systems' HR contract extension, XHRS has nine major new customers. Both companies deem the venture a resounding success, and both have gone forward on a long-term partnership in far better shape than they had entered it—something that is noteworthy in either traditional IT outsourcing or BPO. However, in spring 2009, BAE Systems took some elements of the contract (senior management recruitment) to another provider, showing that the life cycle had indeed come to an end, and that XHRS's offerings had fully matured to a commoditized service.

The enterprise partnership provides a promising alternative to traditional outsourcing for large and complex processes. Yet it is a means to an end, and not an end in itself. The benefits of an enterprise partnership can be substantial. In the case of BAE Systems, the partnership allowed it to outsource fairly complex activities that otherwise would have been difficult to rapidly shift out of the firm. The partnership further yielded $140 million in savings that it might not have obtained in a traditional outsourcing arrangement. However, it is important throughout the agreement to have a vision of the partnership's life cycle and to be proactive about recognizing when it is time to transition to a more traditional outsourcing form.

Notes

1. Mary C. Lacity and Leslie P. Willcocks, eds., *Global Sourcing of IT and Business Services* (London: Palgrave, 2006).
2. See Michael R. Weeks and David Feeney, "Outsourcing: From Cost Management to Innovation and Business Value," *California Management Review*, 50/4 (Summer 2008): 127-146; Mark

Power, Carlo Bonifazi, and Kevin C. Desouza, "The Ten Outsourcing Traps to Avoid," *Journal of Business Strategy*, 25/2 (2004): 37-42. Also, a Gartner Consulting study found that four of five Business Process Outsourcing (BPO) contracts have to be renegotiated within two years, while a Deloitte Consulting survey found that a quarter of outsourced activities end up back in-house. See Lauren Keller Johnson, "Successful Business Process Outsourcing," *MIT Sloan Management Review*, 47/2 (Winter 2006), 5-6; Paul Robinson, *Why Settle for Less? Deloitte Consulting 2008 Outsourcing Report*, London, 2008.

3. For a discussion of the typical steps that firms go through in outsourcing with off-shoring, a related study of the phases firms go through towards effectively off-shoring IT work can be found in Joseph W. Rottman and Mary C. Lacity, "Proven Practices for Effectively Offshoring IT Work," *MIT Sloan Management Review*, 47/3 (Spring 2006): 56-63. We urge readers interested in offshoring any activities to read this work. Like other models, Rottman and Lacity consider only one side of the agreement. We build on their work, and others, to show that the life-cycle considerations impact both sides of the outsourcing agreement. We argue that both sides benefit from consciously planning for each of the discrete stages their outsourcing relationship is likely to evolve through.
4. This is in part for tax accounting purposes. It also makes logical sense as this was the original motivation of the outsourcing project. If the operational improvements only led to an increase in profits for the shared entity, then both client and outsourcing provider would benefit equally as profits are shared.
5. See Leslie P. Willcocks, Mary Lacity, and David Feeney "Transforming Human Resource Processes through Outsourcing," in V. Gover and M.L. Markus, eds., *Business Process Transformation* (Amonk, NY: Sharpe, 2008), p. 280.
6. For another perspective on BAE and Xchanging's early years, see Mary C. Lacity, Leslie P. Willcocks, and David Feeney "Transforming a Back-Office Function: Lessons from BAE Systems' Experiences with an Enterprise Partnership," *MIS Quarterly Executive*, 2/2 (2003): 86-103, and Mary C. Lacity, Leslie P. Willcocks, and David Feeny, "BPO as Enterprise Partnership: The BAE-Xchanging Transformation Strategy for HR Procurement," in P. Brudenall, ed., *Technology and Offshore Outsourcing Strategies* (New York, NY: Palgrave Macmillan, 2005): 133-160.
7. It is interesting to note that these phases are not strictly linear. During one board review meeting at Xchanging we observed how a process that had passed through both alignment and streamlining phases was deemed to be underperforming, so a second "streamlining" phase was decided at the request of the process owner at XHRS.
8. See, for example, Rottman and Lacity, op. cit.; Weeks and Feeney, op. cit.
9. Mari Sako, "Outsourcing versus Shared Services," *Communications of the ACM*, 53/7 (July 2010): 27-29.
10. Natasha F. Veltri, Carol Saunders, and C. Bruce Kavan, "Information Systems Backsourcing: Correcting Problems and Responding to Opportunities," *California Management Review*, 51/1 (Fall 2008): 50-76.
11. Weeks and Feeney, op. cit.
12. The actual deal was a little more complicated, as there was an indexation clause that was applied at the end of each year. This clause included factors, such as a weighted average of labor cost and cost of living (RPI) indices, to determine the exact cost for the second year.
13. For example, in auditing it has been observed that over time, skills become embodied in people and routines and relationship specific assets that enhance the benefits of sustaining a long-term relationship. In an examination of 1884 firms in the early 1980s, Levinthal and Fichman found that the rate of switching was greatest after about four years. However, for firms with very complex auditing tasks, the relationships with external suppliers lasted substantively longer. This is due in part to the value of developing assets specific to the relationship over time. Daniel A. Levinthal and Mark Fichman, "Dynamics of Interorganizational Attachments: Auditor-Client Relationships," *Administrative Science Quarterly*, 33/3 (September 1998): 346-369.
14. Francesco Zirpoli and Markus C. Becker, "What Happens When You Outsource Too Much?" *MIT Sloan Management Review*, 52/2 (Winter 2011): 59-64.

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