MANAGING THE VENDOR SET: ACHIEVING BEST PRICING AND QUALITY SERVICE IN IT OUTSOURCING

Executive Summary

Past research on IT outsourcing has focused on defining best practices, on identifying mature outsourcing attributes, and on how to best manage outsourced projects. However, little guidance exists on best practices of managing multiple vendors (a “Vendor Set”). Not properly managing a Vendor Set can lead to sub-optimal outcomes, such as loss of IT process knowledge, lack of innovation, over spending, and poor quality. This article draws lessons from how one multinational organization manages its Vendor Set in the outsourcing of software development and testing activities. Client managers who outsource to vendors need to establish the appropriate balance between building strong collaborative relationships and encouraging market competition among vendors to ensure best price and service quality.

MANAGING THE VENDOR SET

Global outsourcing for information technology (IT) is a well-established long-term business practice. IT services providers help clients lower costs, achieve variable capacity, mitigate risks, improve processes, access skilled resources, and focus on core competencies. Given the trend to outsource more work, how do client managers ensure that they receive the best price and best service quality from their vendors? Client managers must balance the need to maintain a trusting partnership with each vendor (collaborative relationship) against the need to manage a set of vendors (market competition). We propose that the winning strategy for clients is to manage a small set—which we call the “Vendor Set”—of highly qualified, knowledgeable vendors and occasionally bring new vendors into the set. This strategy will maintain competitive prices and high quality while sustaining collaborative relationships with long-term vendors.

The Vendor Set is a subset of approved outsourcing vendors, either offshore or onshore, routinely engaged in supplying goods and/or services to a client. Managing a Vendor Set is similar to following a multisourcing strategy, which requires constant balancing (see Figure 1). Client managers must not only build strong collaborative

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relationships with each vendor, but also use market competition among Vendor Set members to gain the best price and service quality.

In building collaborative relationships, long-term contracts with high-performing vendors often result in the vendors gaining substantial knowledge about a client’s people, organization, and systems, and, in some cases, learning more than the client about how to perform the client’s work. However, long-term vendors with expert knowledge of a client’s business will keep some knowledge from the client, creating an information imbalance that can be used for their own advantage. While clients want vendors to be well informed in order to perform at optimal levels, clients usually need to reserve some knowledge, especially that of a strategic or intellectual property nature.

**Collaborative Relationships with Vendors**

In collaborative relationships, client managers treat vendor managers and staff as they would full-time client employees by sharing strategic information, inviting vendor employees to corporate events, and socializing with the vendors to encourage them to set goals that benefit the client. To develop a successful relationship with a vendor, a client must demonstrate that it can be trusted regarding information sharing and other aspects of collaboration. A long-term relationship can become complacent, which is exacerbated when the vendor eventually knows how to do the job better than the client does. In the extreme, client-vendor relationships that are too close and proprietary could result in the client losing knowledge, missing out on innovations, and suffering from increased prices and poorer service quality. We argue that clients that successfully outsource their work to vendors are effective both in maintaining collaborative relationships and in mitigating the potential negative side effects by using a Vendor Set to promote market competition.

**Market Competition Among Vendors**

To promote market competition, clients ask members of the Vendor Set to compete for work based on the lowest price and highest service quality. Client managers put bids for new work out to Vendor Set members, ensure each vendor in the set is aware there are other competing vendors, add new vendors to the set when more competition is needed, and accept the best price and work quality option. Client organizations need to contract with at least two vendors if they are to motivate continued performance, keep market pressure on pricing, and reduce the risks of concentrating knowledge at a single vendor. Although using services from multiple vendors increases the costs associated with managing the vendor relationships, the use of multiple vendors has, in general, been successful in mitigating many of the risks associated with outsourcing.\(^5\)

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Challenges to Managing the Vendor Set

Given the need to constantly balance the Vendor Set, client managers are faced with several challenges. They have to routinely identify, qualify, and add new vendors. This process is increasingly handled through a vendor management office and involves corporate lawyers, who negotiate high-level outsourcing agreements, including the terms and conditions of contractual penalties and rewards. Once high-level contracts are established, client managers must manage vendors in the Vendor Set, each of which possesses different levels of knowledge of the client’s business processes.

When a new vendor is added to the Vendor Set, the client must quickly bring that vendor up to the required competency level. Client managers use established members of the set along with their own employees to help transfer knowledge rapidly to a new vendor. To accomplish this rapid communication task, managers may consider the feasibility of co-locating some vendor managers at the client site. They also need methods to evaluate performance and remove low performers from the Vendor Set, being careful to transfer knowledge from a vendor prior to its removal.

Client managers must determine the appropriate number of vendors to include in the set. The Vendor Set should be small enough to control and manage the knowledge that is being transferred while building strong collaborative relationships, but large enough to promote intra-set market competition.

Finally, clients must ask vendors to compete for new business even though they are striving to establish collaborative “friendly” relationships, which requires a delicate balance between honing social relations while pursuing economic goals. How well clients can carry out all these activities will determine their outsourcing success.

A BALANCED IT VENDOR SET: CASE STUDY OF A MULTINATIONAL COMPANY’S SUCCESS

We provide insights from a multinational company’s (the client) experience of successfully maintaining long-term relationships with a balanced set of knowledgeable vendors. We studied a specific type of IT service activity—the software development and testing services environment. This environment includes both tactical and strategic activities for the client, and involves considerable long-term outsourcing. The client runs proprietary, complex software, integrated across multiple semi-autonomous divisions to seamlessly provide superior customer services and operational control. The client’s success depends on the reliability of its integrated systems, which are directly linked to personalized applications provided to its customers.

This client firm has operations in more than 200 countries worldwide, with about 5,500 IT employees overall. An additional senior IT management position responsible for software development and testing was created in 2006, and three directors, 14 managers, and 149 full-time employees provide oversight over the IT outsourcing activities. The client has three or four major releases of hundreds of new and modified software versions a year.

During software development and testing, the vendors’ and the client’s IT employees interact with each other and with business managers across the client organization (e.g., marketing managers, who represent the needs of the customers). Thus the outsourced software development and testing activity includes important tactical and strategic dimensions that the vendors must support.

Our data for this case study was gathered through face-to-face interviews with employees of the client organization and three outsourcing vendors in India with whom the client has had working relationships of varying lengths. We refer to these vendors as “Alpha,” “Beta,” and “Gamma,” not just to distinguish one from another, but also because they represent the three distinct classes of vendor that should be included in a Vendor Set (the characteristics of these three types of vendor are explained in more depth below):

- Alpha has worked with the client since 1999 and has a history of a strong working relationship. It is an IT and business process outsourcing company based in Bangalore, India, with 29 offices in nine countries and delivery centers in India, China, South America, and Europe.

While software testing might be considered a more commodity type of outsourcing for some organizations, in these outsourcing relationships, the shared knowledge about client operations and goals is critical to software testing, given the project complexities, wide-ranging interactions among the entire system development process, and relational demands of providing tailored dynamic services. Thus we believe the results of our study provide general insights for other complex outsourcing contexts.
• **Beta** has worked with the client since 2001 and is a global provider of IT and business process outsourcing solutions, with global development centers in India and the U.S. This firm has worked hard to establish strong relational ties to the client as this work represents a high percentage of its total revenue.

• **Gamma** has worked with the client since 2007 and is a consulting and IT services company based in Hyderabad, India. It operates in 66 countries across six continents. Being the newest vendor in the client’s Vendor Set, Gamma is facing the challenge of building a strong relationship with the client.

In the next section, we describe the importance of these vendor types in creating and managing a Vendor Set. By reviewing related research and comparing those findings with our interview data, we have identified three primary principles for successfully managing a Vendor Set.

**PRINCIPLE 1: CREATE A PORTFOLIO OF VENDOR SET MEMBERS**

Figure 2 lists the 10 benefits of managing the membership of a Vendor Set we have identified. The first six are due to collaborative relationships; the remaining four are due to market competition. The client’s goals are to structure a Vendor Set that capitalizes on the benefits of working with at least one vendor of each type (Alpha, Beta, and Gamma) and to identify potential new vendors.

**Understanding the Vendor Types**

Each of the three types of vendor—Alpha, Beta, and Gamma—together with potential new vendors, has a meaningful role to play in constructing a Vendor Set. A set will typically comprise at least one Alpha, Beta, and Gamma vendor, and possibly more than one of each type.

**Alpha Vendors.** An *Alpha* vendor has a long-term, strong collaborative relationship with a client. Such a vendor understands the client’s operations and strategic goals better than any other vendor type. Much of the work given to an Alpha vendor usually involves strategic-level activities, although some tactical activities may also be included. Client managers often have intimate knowledge of the Alpha vendor’s management style and have personal relationships with its employees. The close relationship between the Alpha vendor in our study and the client was illustrated in this way:

“The client used to ask, ‘Are you capable of doing the work?’ They no longer ask if we are capable because they know we are.” [Alpha manager No. 1 in India]

**Beta Vendors.** A *Beta* vendor’s working relationship with the client is shorter than an Alpha vendor. This type of vendor is in a multi-year process of building a collaborative relationship with the client. The nature of the work given to a Beta vendor involves a higher proportion of tactical activities but will include some strategic-level activities so the client can see how the vendor uses the proprietary information. Client managers have some knowledge about the management style of a Beta vendor’s organization but are still learning. Beta vendors aspire to become Alphas. A client manager offered his opinions on moving a Beta to the Alpha level:

“... there is an interaction between trust and risk. If I trust them, I may get a big reward. I’m willing to take that risk to give more work and information [to the Beta vendor], and over time and as the relationship matures [moves toward Alpha level], I’m willing to take the risk more and more. They prove to me over time they can handle it, they aren’t abusing having this important information....

“Recently I gave the [Beta] vendor some very important and sensitive data which would hurt our brand if it were released to the public. They are under a non-disclosure agreement, but if a malicious vendor wanted to share it, it would be difficult to prove what happened. If I don’t take the risk to share it, though, there is no benefit. I can be conservative and not share, which is a sign of an immature relationship. The more mature it is, the more risks are taken.” [Client manager No. 1]

**Gamma Vendors.** A *Gamma* vendor is the newest member of a Vendor Set. This type of vendor knows much less about the client than Alpha or Beta vendors and is striving to build closer ties with the client. Although a Gamma vendor brings new ideas and competition to the Vendor Set, it lacks the in-depth understanding of the client’s operations and strategic goals necessary for applying new and innovative ideas. The nature of the work given to Gamma...
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Figure 2: Managing Membership of the Vendor Set

<table>
<thead>
<tr>
<th>Client Benefits Due to Collaboration</th>
<th>Alpha Vendors</th>
<th>Beta Vendors</th>
<th>Gamma Vendors</th>
<th>Potential New Vendors</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Search efficiency</td>
<td>High</td>
<td>Medium</td>
<td>Low</td>
<td>Very Low</td>
</tr>
<tr>
<td>2. Operational knowledge of client business</td>
<td>High</td>
<td>Medium</td>
<td>Low</td>
<td>None</td>
</tr>
<tr>
<td>3. Investment in the relationship</td>
<td>High</td>
<td>Medium</td>
<td>Low</td>
<td>None</td>
</tr>
<tr>
<td>4. Handling requirement uncertainties</td>
<td>High</td>
<td>Medium</td>
<td>Low</td>
<td>Unknown</td>
</tr>
<tr>
<td>5. Relationship quality (trust, commitment, culture)</td>
<td>High</td>
<td>Medium</td>
<td>Low</td>
<td>Unknown</td>
</tr>
<tr>
<td>6. Price reduction absorption</td>
<td>High</td>
<td>Medium</td>
<td>Low</td>
<td>Unknown</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Client Benefits Due to Market Competition</th>
<th>Alpha Vendors</th>
<th>Beta Vendors</th>
<th>Gamma Vendors</th>
<th>Potential New Vendors</th>
</tr>
</thead>
<tbody>
<tr>
<td>7. Price lowering catalyst</td>
<td>Low</td>
<td>Medium</td>
<td>High</td>
<td>Very High</td>
</tr>
<tr>
<td>8. New ideas/innovations sharing</td>
<td>Low</td>
<td>Medium</td>
<td>High</td>
<td>Very High</td>
</tr>
<tr>
<td>9. Work-effort transparency</td>
<td>Low</td>
<td>Medium</td>
<td>High</td>
<td>None</td>
</tr>
<tr>
<td>10. Pricing transparency</td>
<td>Low</td>
<td>Medium</td>
<td>High</td>
<td>None</td>
</tr>
</tbody>
</table>

Potential New Vendors. Potential new vendors to the Vendor Set have no prior history of working with the client but exhibit the capabilities to provide services in the future. The nature of any work given to potential new vendors before they become formal members of the Vendor Set involves solely tactical-level activities. There is very little knowledge exchange between a potential new vendor and the client, and its inclusion in the Vendor Set is by no means certain. However, giving work to a potential new vendor increases the awareness of competition among those already in the Vendor Set.

Moving Between Vendor Types. Given that client-vendor relationships vary across vendor types, client managers work with the vendors in each category in different and unique ways. They should recognize that one of their goals is to systematically move vendors from potential new vendors to Alpha status. However, it is not sensible to move all vendors to the Alpha level simultaneously because the resulting lack of market competition could lead to increased prices and reduced service quality. The opposite holds as well: client managers should not attempt to keep all vendors at a distance, treating them as potential new vendors, as this may result in inefficiencies in searching for new vendors.

Benefits Achieved From Collaborative Relationships

Achieving the first six client benefits listed in Figure 2 requires strong collaborative relationships, such as those with Alpha vendors.

Benefit 1: Search Efficiency. Search efficiency reflects how easily clients can find new vendors to communicate with as well as negotiate the contract terms and conditions and service level agreement.

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8 The rating of client benefits by vendor type on a scale from Low to Very High is based on our reading of the extensive literature discussed earlier and observations in our case study. We present these ratings to convey management guidelines, but it should be recognized that further research is needed to determine the extent to which they hold true for each type of client benefit in typical Vendor Set management situations.
(SLA) details. Search efficiency is very low when opening up bids to an unlimited number of potential new vendors since the client must seek out many, sometimes unknown, vendors and incur the costs of communicating work details and negotiating contracts. The high cost of searching for new vendors (i.e., low search efficiency) makes client firms less likely to seek out new vendors to bid on work.

Search efficiency is highest when dealing with Alpha vendors, as there is already a strong collaborative relationship, and the additional cost communicating with such vendors is minimal. Our interviews support this view, with one client manager telling us:

“Keeping an existing vendor is generally more cost-effective for us because domain expertise is built over time, and relationships are in place.” [Client manager No. 2]

Moving from left to right in Figure 2, search efficiency decreases to Medium when dealing with Beta vendors. Clients have previously worked with these vendors and their working knowledge of the client’s operations acts as a baseline for contract negotiations. Search efficiency again decreases when dealing with Gamma vendors. The client has already identified these vendors but has not shared detailed knowledge about work processes, which will incur costs when asking them to bid for new work.

Benefits 2 and 3: Operational Knowledge of Client Business and Investment in the Relationship.

These two benefits are synergistic, as operational knowledge seems to lead to greater investment in the relationship. Clients expend resources on educating vendors about the essential industry- and firm-specific knowledge that is needed to build, run, or improve the outsourced operations. Both client and vendors use this operational knowledge to make specific investments over time in their joint work processes to extend and strengthen their relationship. Each party adopts proprietary and customized assets in their work environments to smoothly transition work between the assets.

Long-term relationships allow each party to invest heavily in relationship-specific assets. This investment occurs when vendors build domain knowledge of the client’s business, adopt specialized facilities and technology to support client services, and develop a high degree of information and knowledge specifically about the client’s operations. The clients and vendors work together over a longer period of time using dedicated resources to share operational knowledge and invest in the relationship. Operational knowledge of the client’s business and investment in the relationship are almost nonexistent when contacting potential new vendors. Usually, such vendors have no history of working with the client.

Moving from left to right in Figure 2, operational knowledge and investment in the relationship is highest when dealing with Alpha and Beta vendors. Clients have a history of working with these types of vendors and will have already shared considerable knowledge about their operations. Operational knowledge and investment in the relationship are low when dealing with Gamma vendors as the client has a shorter history of working with these vendors, and only limited knowledge about work processes has been shared with them.

Benefit 4: Handling Requirements Uncertainties.

Long-term relationships also enhance the vendors’ abilities to be more flexible in handling requirement uncertainties (e.g., predicting the work that will actually be performed). The inherent uncertainty in many IT software development and testing processes compounds the coordination problems caused by the size and scope of projects. The uncertainty also increases the complexity of managing the flow of work between the client’s IT organization, the outsourcing vendors, and other client departments.

Unlike manufacturing, software development and testing is a non-routine activity. Many software systems are one-of-a-kind projects or contain complex interdependent components. Uncertainty in software development and testing relates to the unpredictability of both the work outcomes and the specific tasks that vendors will be asked to perform. Further, uncertainty increases because specifications of the software’s functionality change over time and requirements are rarely complete.

As vendors learn more about the client, they develop implicit knowledge that creates confidence in their ability to use experiences of past engagements to help predict future work requirements. This level of confidence can only be achieved over time. Thus how...
well potential new vendors will handle requirements uncertainties is unknown because they have no history or prior experience of working with the client.

Handling requirement uncertainties is low when dealing with Gamma vendors because of their experience of working with the client. It increases when dealing with Betas because they have a longer history of working with the client. It is highest when dealing with Alpha vendors, due to their knowledge of the client’s operations and experience in dealing with the client. One client manager told us:

“If I have to build a contract where I think ahead of time what is going to happen in 6 months or a year or 18 months, I cannot see that far out. It is too dynamic. So I need a relationship that is more mature, that says I understand these things are going to change and, as a part of our working together, we are going to work with you on these types of things.” [Client manager No. 1]

**Benefit 5: Relationship Quality.** Long-term relationships, especially in outsourcing, thrive when trust, commitment, and culture all positively impact relationship quality. By definition, this will be highest for Alpha vendors and non-existent for potential new vendors.

**Benefit 6: Price Reduction Absorption.** The final client benefit from collaborative relationships is when current vendors exhibit price reduction absorption (i.e., significantly reduced prices over time). As a result, the client is less likely to seek out potential new vendors to bid on new work. Over time, as vendors gain greater operational knowledge, make more relationship-specific investments, and better understand uncertain requirements, they are in a position to offer lower prices. Vendors can use their operational knowledge to implement improvements in work processes and, if they believe they will get additional future business, they have an incentive to pass on reduced costs in the form of lower prices. One client manager told us:

“Mature organizations also realize that continuous improvement and innovations are needed in order to remain profitable. So as long as prices are reducing, and the vendor is becoming more efficient, which the threat of other vendors brings, we stay with our vendors long-term.” [Client manager No. 2]

**Benefits Achieved From Market Competition.**

The remaining four benefits listed in Figure 2 come from leveraging greater market competition, which reduces the risks of overpricing and quality-complacency involved with working with just one vendor.

**Benefits 7 and 8: Price Lowering Catalyst and New Ideas/Innovations Sharing.** These benefits can be achieved through increasing market competition and communicating with many vendors. Innovative ideas come from leveraging work that vendors perform for other clients. These ideas come from scanning loosely tied networks that generate new innovations in IT work practices. Reaching out to a larger number of potential vendors allows clients to negotiate better contract pricing and service quality and to learn about new ideas and innovations.

Long-term Alpha and Beta vendors can only go so far in implementing best practices in IT processes, and new ideas are needed to progress further. Thus, the price lowering catalyst and new ideas/innovations sharing benefits are very high when dealing with potential new vendors because such vendors encourage established vendors to lower prices and suggest process improvements. These benefits are lowest when a client engages solely with Alpha vendors.

New ideas/innovations sharing depends on, but is not equivalent to, a vendor developing deep operational knowledge of the client’s business. A deep understanding of the client’s operations and business environment creates the opportunity for a vendor to incorporate more efficient and effective ways of working. While Alpha vendors are in the best position to have an in-depth understanding of how to manage a client’s outsourced activities, without incentives, they will likely not share new ideas and innovations. By not sharing these ideas, Alpha vendors can benefit from any gains resulting from more efficient

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and effective ways of working. Thus competition is needed to prompt the sharing of new ideas and innovations, and the way to achieve this is for a client to communicate with many vendors.

In addition to fostering market competition, our case study client attempts to prompt the sharing of new ideas and innovations by developing unique SLA measurements that capture the level of sharing of operational knowledge and new ideas and innovation. While in its infancy, both the client and the vendor concerned are hopeful that these measurements will contribute to the stronger alignment of both parties’ goals toward providing continuously better pricing and service quality. Regardless of the outcome, the process of establishing and collecting these measurements highlights how important this client felt about the need for its vendors to share and adopt new ideas and innovations.

Benefits 9 and 10: Work-Effort Transparency and Pricing Transparency. A client manager in our case study stated that adding new vendors into the Vendor Set could encourage greater work-effort transparency and pricing transparency. With a majority of the work being performed at off-site vendor locations, client managers cannot readily observe work routines or pricing components (e.g., how many people are working on a job). This lack of transparency leads to misunderstandings between the client and vendor and to discomfort among the client managers, whose own performance depends on vendor work outcomes.

The client found that the Alpha vendor was not open to sharing details about effort and pricing and wanted to retain the benefits of keeping this information private (in other words, there was “information asymmetry” in the relationship). For example, the vendor would not share the total number or names of employees assigned to the client, to prevent the client from interfering in the vendor’s ability to manage its resources. A vendor manager put it like this:

“This is a fixed-price contract, and I do not want the client telling me how many staff members to assign to different aspects of the job. I need to manage the work as I need to.”
[Beta manager No. 1 at client site]

To remedy this, the client identified new vendors that were hungry for its business and, if asked, would offer greater transparency in their work-effort and pricing. Once one vendor shares this information, other vendors are compelled to do the same to ensure they will be considered for future work. Thus work-effort and pricing transparency are highest when Gamma vendors, the newest members of the Vendor Set, are encouraged to share their private information. They are lowest when just Alpha vendors are asked to do the same.

**PRINCIPLE 2: ENSURE ADEQUATE COMMUNICATION WITH VENDOR SET MEMBERS**

Given the benefits of managing multiple vendor types and the dynamics associated with vendor movement within and into the Vendor Set, our case study client used several important communication techniques in its management of Vendor Set membership. Figure 3 illustrates the types of communication (formal and informal) and the direction of communication among the Vendor Set members and between the client and potential vendors.

The combination of large projects, uncertainty, and interdependence of IT project components requires special coordination techniques. One technique is to adopt formal procedures to coordinate communication among the client IT organization, vendor employees, and other client departments. These formal procedures include both technical and managerial communications. Examples of the former are mandating the use of version control software, computer-aided software engineering (CASE) tools, and specification languages. Examples of the latter include written development and test plans, delivery schedules, requirements documents, status review meetings, and automated reporting and tracking of software errors.

While formal communications help to reduce misunderstandings and set appropriate expectations for outsourced IT work, they only partially address the problems of coordination. The challenge is that people with different perspectives must still agree on what is to be accomplished. Meeting this challenge also requires informal communication, which involves personal, peer-oriented, interactive dialogs. Informal, interpersonal communication is the primary way that information flows into and through large organizations and is especially important for coordinating activities as tasks become more uncertain.

Two examples from our interviews illustrate how client managers communicate with each type of vendor in different ways, using both formal and informal communication techniques.
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“Communication is ... not just written and/or formal. It happens on a continuum, it is all of those things. I think about my 23-year marriage and things I used to have to talk about, which are now communicated in one glance or look. ... This is the same in a business relationship. Formal ways are used in the beginning of the relationship, then more informal and more different ways are used later to get the message through. If things are going well, informal communications are just fine, but when and if things go bad, this may cause problems. In younger [Gamma] relationships, if there is a problem, the players will go through a formal grievance process and escalate problems and, in the process, lose business. Mature [Alpha] relationships have informal networks. The vendor can call me, and we will work to fix it together. ... Or we revert to formal communications, and say, 'I'm not understanding you, please put it in an e-mail to me.' We use these methods to clarify communications.” [Client manager No. 2]

“From a legal perspective, nobody will work without a contract. Your whole operation is at stake. It just probably isn’t going to happen, but a flexible contract and flexible informal approach where there is enough flexibility built into these can occur. And an understanding between the two groups that we understand that the kind of flexible relationship that you are after will come to the table because there is this long-term, mutually beneficial opportunity that we’ll work together.” [Client manager No. 1]

Our case study client carefully engages in communication practices that treat each Alpha, Beta, and Gamma vendor as a collaborative partner. The longer the vendor has been in the Vendor Set (i.e., an Alpha), the more strategic-level information is shared. Furthermore, all members of the Vendor Set are asked to report jointly and to jointly resolve problems. The vendors also have co-located office space at the client site, which increases the transparency across vendors regarding price and service quality levels. At the same time, client managers work with their vendor management office to seek out potential new vendors, adding new ones to the Vendor Set and removing non-performing ones.

Because the vendors are co-located, the client is able to hold meetings efficiently with multiple on-site development and testing vendors. This creates an environment for the vendors to informally share their operational knowledge of the client’s business as well as best practices on how to build a better working relationship with the client (i.e., it encourages greater work-effort and pricing transparency). Additional benefits of this strategy are increased competition...
among the vendors, resulting in them providing the best price and service quality offerings.

**PRINCIPLE 3: ADOPT STRATEGIES TO MANAGE THE NUMBER OF VENDOR SET MEMBERS**

When clients add vendors to the Vendor Set, vendor opportunism (i.e., the opportunity for vendors to use their private information to their own benefit without sharing the benefits with the client) is reduced. The downside is that the cost of managing the Vendor Set increases (see Figure 4). Adding new members promotes price and service quality competition; however, each new vendor increases the client’s overhead costs due to the need to negotiate more contracts, to interact with more vendor employees, and to support more knowledge transfer. The arrow in Figure 4 represents the cost-benefit tradeoff between the increasing costs of managing more vendors and the increasing benefits of reduced vendor opportunism.

On the left of the figure is the strategy of single-sourcing or building one collaborative relationship. Here, clients negotiate with one vendor for all their outsourcing work. The cost of working with the vendor is low because a strong, trusting, collaborative relationship with one vendor is pursued, saving time and money by not having to negotiate multiple contracts and search for and engage with multiple vendors. But this strategy leads to a greater risk that the vendor may not be competitive on price and service quality because there is no competition for new business.

In contrast, the far right of the figure illustrates a client working with a large number of vendors in relationships that are very costly to maintain. The cost of continually searching for new vendors, negotiating new contracts, sharing business process knowledge, and monitoring and controlling the vendors’ work makes this level of vendor management less attractive. Thus, the goal of the client organization in IT outsourcing is to find the optimum number of vendors that keeps the overhead costs of working with vendors and searching for new vendors to reasonable levels, while encouraging market competition by including multiple vendors. As one client manager told us:

“At one time, we had too many, so we cut back on the number. You cannot go to too many vendors; the costs and chaos are too high. With a new bid, first we see if those we have an existing relationship with [the Vendor Set] can do it. Then we go to new vendors to see what they can offer.” [Client manager No. 2]

Our case study client currently includes one Alpha, one Beta, and one Gamma vendor in its Vendor Set.

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14 An exception is complete commodity-type outsourcing, but this is rare in IT outsourcing.
It also continuously communicates with potential new vendors. The vendors included in the Vendor Set are chosen based on the complementary skills each provides. This client selects vendors based on their service offerings, their presence in certain global locations, and their competitiveness in delivering services. All three vendors in the Vendor Set (and sometimes also potential new vendors) are asked to bid for new work, and the contract is awarded on the best price and service quality responses to the request for proposals (RFPs).

**GUIDELINES FOR MANAGING A VENDOR SET**

The three principles above propose that client managers should create:

- A portfolio of vendors of different types (Alpha, Beta, Gamma) while also seeking potential new vendors to add to the Vendor Set.
- Use a variety of communication techniques.
- Adopt the appropriate strategy to manage the number of vendors in the Vendor Set.

We now provide seven guidelines for client managers to follow in implementing these principles for managing the Vendor Set.

**Guideline 1: Encourage Price and Service Quality Transparency**

Vendors know their own cost structures and capabilities but may try to keep this information private so they can use it for their own advantage in contract negotiations. By developing the right mix of Vendor Set members and potential new members, our case study client encourages vendors to share price and service quality information. For example, client managers located the on-site vendor employees in the same office to increase the transparency of work and encourage joint reporting. One vendor manager told us:

“As a sign of maturity, the client, another vendor, and we do joint reporting. All three major vendors use shared, informal guidelines to complete the work, and we do not poach on each other’s resources.” [Gamma manager No. 1 at client site]

Since vendors want future work, they will reveal private information to ensure they will be considered for future contracts.

**Guideline 2: Negotiate Fixed-Price Contracts with SLAs**

To reduce vendor opportunism, our case study client negotiates fixed-price contracts with SLAs that require bi-lateral knowledge transfer. Fixed-price contracts provide incentives to become more efficient and innovative, helping to align the goals between the client and vendors. Becoming more efficient allows a vendor to gain additional benefits from a fixed-price contract. However, the SLAs provide incentives to share and adopt innovations to improve work processes, including those resulting in work efficiencies. Two client managers commented on this:

“We use a combination of fixed-price based contracts using performance metrics [in SLAs] to objectively measure and manage project services provided.” [Client manager No. 2]

“Most important is the sharing of continuous improvement ideas. In a mature [Alpha] relationship, because of the trust that is built, and the vendor knows more work will be given to them (so they will be able to grow their business), the vendor will bring these ideas to us if we compel them to do so. There are two dimensions: Whatever the level of work, they need to be comfortable to bring us improvement ideas. ... I ask for 30% improvements [as part of the SLAs], and they know we’ll cut 30% out, but they will get more work in return. ... If they do a proof of concept of new improvement ideas, and that new idea gets put out to bid, we would give them the first opportunity to deliver on that proof of concept.” [Client manager No. 1]

A vendor manager told us:

“The SLAs say that for every [software] release, we must improve. So we have to improve quickly. In 2005, about 70% was automated. Now, we continuously go to automation. We have knowledge sessions where we share ideas. ... We need flexibility, and we are open to ideas. ... We do proof-of-concepts for new ideas first and share the results. We took software testing time from five days to a two-day cycle.” [Beta manager No. 2 at client site]

**Guideline 3: Put New Work Out to Bid to Multiple Members of the Vendor Set**

To further reduce information asymmetries and the potential for opportunistic behavior, our case study
client puts new work out to bid and then gives the new work to members of the Vendor Set with the strongest skills and competitive pricing. This encourages vendors to disclose their best price and service quality solutions when competing for new business. Two different vendor managers told us:

“Now, [the client has] three vendors in-house; we compete on bids, with proposals [that highlight] our capabilities to deliver. We think best practice is having two vendors—as the most mature organizations do ... clients are wary to give one vendor all the work.” [Beta manager No. 1 at client site]

“Sometimes we propose a new idea, and the client likes the idea and decides to write an RFP and open it up for bidding. This has happened many times. Yes, this dampens our desire to bring new ideas in the future. But about 30% of the time, we get the business. So we keep providing them with our ideas.” [Gamma manager No. 1 in India]

**Guideline 4: Foster Flexibility in the Relationship**

Our case study client works flexibly with the vendors outside the terms and conditions of the contract. By balancing a portfolio of vendors, the client can encourage vendors to deliver more, to remain flexible in what is delivered, and to do what it takes to get the job accomplished successfully (i.e., provide a high level of service quality). The client must also be flexible in working with the vendors beyond the contract terms, with some “give and take” to satisfy both parties and ensure that any changes of this type are mutually beneficial. Three responses from our interviews illustrate this point:

“I’m really looking for flexibility in the contract with the vendor. If it gets to the point where I’m having to review the terms and conditions on the contact, then I think the relationship has failed. ... Contracts and SLAs are a critical area when the relationship and/or work is going bad. If this happens, we all turn to the contract to look at it and hold people accountable. Trust and strongly built relationships are the key when the relationship and/or work is going well. In other words, if you have to turn to the contract, then you are in trouble.” [Client manager No. 1]

“Because of operational issues, we’ll be testing the software, and it is a big corporate release, and the product has a real critical set of defects that we didn’t plan on. But you know what? If I don’t get this done, it doesn’t go out, our company [the client] really suffers. So I want flexibility from the vendor or partners to say, ‘Ok, it wasn’t in the plan, but here is how we can adjust, and we’ll figure out all that after the fact.’ Don’t hold me to that before the fact. It is the middle of the crisis, so don’t [say], ‘Ok, if you give me another $100,000, I’ll do it.’ If there is enough mutual respect and trust, we’ll fix the problem, then we’ll work it out. You have trust in me that I’ll be doing right by you, and you’ll be doing right by me.” [Client manager No. 2]

“After 12 to 18 months, the relationship becomes a partnership. To get into a partnership, both parties must be flexible. This means ‘do not talk about the contract.’ The contract is a legal thing, and the relationship is really with the project teams. Our management team does talk about the contract, of course, but they talked to our own team about how we should abide by the contract. When interacting with our client, both sides [mutually agree] that we don’t talk about the contract.” [Alpha manager No. 1 in India]

**Guideline 5: Use Informal and Formal Communications Inside and Outside the Vendor Set**

The nature of coordinating IT outsourcing work dictates the need to use both formal and informal communication methods. The interdependence of work processes means contracts, statements of work, and SLAs are managed by written, formal means. But the coordination of the work is often better managed through more informal interpersonal communication. Our case study client also encourages informal communications among its vendors to encourage competition.

This client organization uses these communication procedures to dynamically manage its Vendor Set and to encourage multisourcing and market competition. To achieve the dynamic movement of Vendor Set members from Gamma to Beta to Alpha, the client evaluates what vendors outside the set have to offer. The dialog with potential new vendors makes existing Vendor Set members aware that quality alternatives are available, increases the client’s understanding of whether Vendor Set members are offering the best price and service quality, and allows these vendors to assess what the competition is doing.
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Furthermore, the client periodically adds new vendors to the Vendor Set and removes non-performing or unneeded ones to keep the set fresh. Vendor managers told us how SLAs and the relationship can be used as a means of formal and informal communications for putting pressure on vendors to perform:

“[SLAs] are reviewed quarterly, and we must adhere to them. If we miss them for two quarters, we may lose the contract.” [Gamma manager No. 1 at client site]

“SLAs are only as good as their enforcement. At this client, only some are enforced. But the pressures are there anyway because of the relationship. SLAs are not a driver; the relationship is. We don’t want to lose this account to another vendor.” [Beta manager No. 2 at client site]

**Guideline 6: Share Operational Knowledge While Seeking Out New Ideas and Innovations**

One benefit of long-term client-vendor relationships is that vendors develop a deep operational knowledge of the client’s business. Our case study client and its vendors work together over time using dedicated resources to share knowledge. However, long-term relationships may lead to complacency or the lack of fresh ideas. Our interviews indicated how the benefits of sharing new ideas and innovations can be achieved by bringing in new vendors. Innovative ideas come from leveraging work that vendors perform for other clients. Reaching out to potential new vendors allows clients to learn about new ideas and innovations.

Client managers must consider the balance of sharing deep operational knowledge with long-term vendors and encouraging them to provide new ideas and innovations. This is accomplished by putting work based on new ideas and innovations out to bid among the Vendor Set members and potential new vendors to create pricing and service quality competition. A vendor manager told us:

“We deliver ideas. We pilot them to show they are OK, and then there is a built-in expectation to use this new idea the next time around. The ideas are then pumped to all the vendors, to spread the knowledge to other vendors. We present the improvements to the client. ... If we are given a stake in the savings, we will identify more innovations; so they promise to involve us in more business and at more strategic levels. We want continued business and a larger footprint. ... We gave more than what was in the contract.” [Alpha manager No. 1 at client site]

**Guideline 7: Retain a Small Set of Trusted Vendors**

Each new vendor added to the Vendor Set to promote price and service quality competition increases the client’s overhead costs. We recommend that clients should maintain a Vendor Set with at least one of each vendor type, with the vendor choices based on obtaining the best mix of skills and other factors considered important. Our case study client considered the service offerings each vendor could provide, its presence in the required global locations, and its ability to compete in delivering services. To achieve its desired set of trusted vendors, this client determined that the optimum number of vendors was three, one of each vendor type. In the future, however, the client might include more than one vendor of specific types as its needs change.

**APPLYING THE GUIDELINES TO OPTIMIZE YOUR OWN VENDOR SET**

Client managers must assess what type of multisourcing strategy is optimal for their organization’s long-term IT outsourcing strategy. Our case study indicates that managers should think beyond outsourcing to a single vendor, to creating relationships with a small number of vendors—the Vendor Set—which should then be dynamically managed. We have illustrated how a strong trusting and collaborative relationship built between a client and a vendor does not exist in isolation but exists alongside other relationships maintained within a portfolio of vendors.

Not all vendors will achieve Alpha status. Client managers should work to create long-term, trusting and collaborative relationships with talented vendors by offering them greater work volumes and higher-level strategic work activities. A vendor will achieve the trusted Alpha status once it has demonstrated it is capable of delivering high-quality services without abusing its access to the client’s strategic and detailed operational knowledge. When considering whether to move an additional vendor toward Alpha status, client managers should keep in mind the benefits of having vendors of all types in the Vendor Set. Having multiple vendors covering each type of vendor balances the benefits gained from building strong...
collaborative relationships with the benefits gained by encouraging an environment of market competition among the Vendor Set members. It also offers client managers the flexibility to achieve the appropriate balance to ensure best price and service quality.

The three principles and seven guidelines set out in this article provide a basis for organizations to improve the management of their IT outsourcing vendors and increase the benefits from outsourcing. Client organizations can optimize the types and numbers of trusted vendors to create the best balance between benefits based on collaborative relationships and benefits based on market competition.

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