HHS CIRCULAR C-018

HHS Guidance for Outsourcing Decisions

Purpose

The purpose of this guidance is to strengthen the process through which Health and Human Services (HHS) agencies determine when the state's interests are best served by contracting for the provision of certain services or functions as opposed to providing the services directly using state employees. Since many support services or programmatic services can be provided in-house or by the private or nonprofit sectors, such "make or buy" decisions arise with increasing frequency. The quality of these decisions is critically important to the quality and cost of health and human services programs.

This guidance primarily focuses on the process for determining whether and how to outsource a function after a decision has already been reached that a service or function is appropriate for outsourcing consideration. In particular, the guidance focuses on the financial analysis supporting decisions regarding outsourcing. The guidance is also oriented toward projects involving services that are not currently outsourced, although portions of the guidance would be of value where a currently outsourced service is being re-procured. Another situation where only portions of the guidance are applicable is when an agency is contemplating a procurement that would use an existing state contract instead of conducting its own procurement process.

Some Activities are not Appropriate for Outsourcing

HHS agencies recognize that the private or nonprofit sectors can sometimes deliver a service or perform a function with higher quality and/or at less cost than the state. HHS agencies also recognize that the prospect of competition from the private or nonprofit sectors can sometimes stimulate state agencies to be more efficient or effective in directly providing a service. At the same time, it is recognized that some functions are most appropriately provided directly by the state. Examples include judicial functions, regulatory functions or the fiduciary responsibilities for state resources.

Context for Outsourcing Decisions

An evaluation of whether to outsource a function or service is sometimes the result of external direction, such as statutory direction, to an agency. At other times outsourcing is an internally generated option as an agency seeks more efficient or effective ways of conducting business. External direction regarding outsourcing sometimes includes specific factors to be considered.

Generally though, the specific considerations involved in an outsourcing decision are the same regardless of whether the impetus to consider outsourcing was internally or externally generated.

Outsourcing feasibility studies or outsourcing decisions are typically linked to procurement processes. An outsourcing feasibility analysis is sometimes conducted in advance of a procurement process with the initiation of a formal procurement process being based on the outcome of the feasibility analysis. In such cases, the information developed for the feasibility analysis may flow directly into the subsequent procurement process. For example, information from a feasibility analysis may be of critical importance in developing a request for proposals (RFP). In exceptional cases, a procurement process potentially leading to an outsourcing decision may be initiated without a feasibility analysis being conducted first. Typically this would be based on statutory direction. The initial research and analysis of the outsourcing option will then be done as part of the detailed planning that shapes the development of the RFP. With outsourcing projects, as with any contracting process, the planning and analysis performed at the beginning of the process is a major key to a successful outcome.

Decision Support for Outsourcing Projects

In addition to the contact manuals of individual HHS agencies, five reference documents are of particular value for HHS employees engaged in procurement and contracting in general and outsourcing projects in particular. They are the *Guide to Cost Based Decision Making* (published by the State Auditor's Office), the *HHSC Contract Manual*, the *State of Texas Contracting Guide* (published by the Texas Building and Procurement Commission), the *Cost Methodology* (published by the Council on Competitive Government), and the *Procurement Manual C* (prepared by Enterprise Contract and Procurement Services).

Defining The Service Or Function To Be Outsourced

The *Cost Methodology* identifies the first step in an outsourcing analysis as "defining the service to be outsourced." The *State of Texas Contracting Guide* and the *HHSC Contract Manual* both identify planning for a contract as the critical first step in a procurement process. One of the key outcomes from the planning phase of a project is a statement of work that normally becomes a key component of a request for proposals (RFP). A statement of work is a description of the service the state seeks to purchase. In an outsourcing context, it defines the state's vision of the service or function it is considering outsourcing.

In defining a service to be outsourced or preparing a statement of work to be performed by a contractor, it is critical that the service be described thoroughly and accurately. If the service is not adequately defined, a contractor will not be able to submit proposals that convey all the information the state will need to make a sound final decision on whether to outsource. Insufficiently or inaccurately defining the service to be outsourced, or the statement of work, will also undermine the ability to develop key contract provisions at the end of the procurement process. This would include the provisions that define the performance standards the contractor must meet.

Precisely Defining the Scope of the Potentially Outsourced Function or Service

One of the key aspects of thoroughly defining the service to be potentially outsourced involves identifying the scope of the service clearly and in detail. Initial discussions of a potential outsourcing effort may address a broadly defined function or service, such as accounting, human resources or the operation of a state institution. The planning and analysis that lead to a sufficiently thorough and detailed statement of work fully identifies the sub-functions or sub-processes for which a vendor would be responsible. For example, in a statement of work for outsourcing management of a state residential institution, a vendor would need to know who is responsible for the medical care of residents. In outsourcing an accounting function, a vendor would need to know who is responsible for preparation of annual financial reports. The key is to identify sub-functions that create a distinct service element or external deliverable to customers. This is in contrast to emphasizing the identification of work steps or sub-processes that a vendor might wish to reengineer or eliminate in efficiently providing a service.

Precisely defining a service or function for outsourcing consideration can be very challenging. The staff involved must have a detailed understanding of the function. This includes understanding relationships with other services and support functions. Inadequately defining the function to be outsourced can lead to poor results. There may be a failure to optimize the outsourcing project in terms of operational effectiveness and efficiency. Later in the procurement process there may be an inability to validly compare the costs of outsourcing with the cost of directly providing a service. Final refinements in identifying sub-functions, sub-processes and related performance standards can also occur when the framework of potential alternatives becomes known.

Establishing Performance Requirements for the Potentially Outsourced Service

The other key element involved in fully defining a service in conjunction with an outsourcing project is establishing the performance standards a contractor must meet. The performance standards should address all aspects of the contractor's performance for the service provided. The standards must focus on outcomes rather than on intermediate work steps or work products. Focusing performance standards on intermediate work steps or activities has the effect of prescribing how a service should be delivered and may limit a vendor's ability to use more innovative or efficient approaches. One of the goals of an outsourcing project should be to benefit from the alternate methods of delivering a service that a vendor may be able to offer.

Identifying performance standards requires the involvement of staff with deep and broad knowledge of the services or functions undergoing outsourcing analysis. Ensuring an understanding of the performance needs of the customers or clients is one of the keys to successfully establishing performance standards. Another key is to address any externally imposed performance standards. Performance standards may be externally mandated by the federal government, court orders, legislative enactments and regulatory or accreditation organizations.

Conducting the "Make or Buy" Comparison

The culminating and most complex aspect of an outsourcing procurement project is the analysis and evaluation of proposals submitted by vendors interested in performing a service or function for the state. The focus of this guidance is the comparison of the most attractive vendor proposal against the option of the state providing a service or function directly using its own employees. The option of the state providing the service should be looked at in terms of the continuation of current state operations or as a scenario in which the state improves or optimizes its operations. The same comparative methodology can be employed if it is necessary to compare more than two options.

The foundation for a successful make or buy comparison should already have been partially developed by preparing a thorough and accurate statement of work to serve as the basis for soliciting meaningful proposals from vendors that address the state's requirements and needs. The other major component of the make or buy analysis is the framework for directly comparing the available options. Two elements are essential to validly comparing these options.

- The analysis must truly be based on comparisons of the same service or function in relation to scope, quality and performance standards.

- The analysis of costs must thoroughly consider all elements of cost involved in providing a service and all costs impacted by the manner in which the service is provided.

The preceding sections have discussed the necessity of thoroughly defining the scope of the service to be outsourced. Equally critical to the outsourcing analysis is thoroughly defining the scope and quality of the service or function as it is already provided by the state or as it would be directly provided by the state in the future. It is especially important to consider whether the state already meets all performance standards being required of a vendor. If the current state operation differs materially in scope or quality from the service as it would be performed when outsourced, the make or buy analysis must reflect the state's operation as it would need to be adjusted to match the requirements of the statement of work and request for proposals presented to vendors. This becomes very important in the cost analysis. The state's operation, for purposes of comparison, does not need to use the same approach to delivering a service as proposed by the vendor. However, it should be based on the same scope of service and the same performance requirements and standards.

The *Cost Methodology* of the Council on Competitive Government provides a detailed approach to comparing the costs of providing a service in-house with the cost of providing a service through outsourcing. Three broad steps are involved:

- determining the total in-house costs;
- determining the total cost to outsource; and
- determining any savings from outsourcing.

Determining Total In-House Costs

With respect to determining in-house costs, the *Cost Methodology* provides general guidance on how to approach the exercise of determining the in-house costs. An additional consideration that may be applicable in some cases is the need to make any necessary adjustments in estimating the in-house costs if the historical or current state costs are not representative of the scope and quality of the service envisioned under an outsourcing scenario.

The agency may also need to consider adjustments from current or historical costs, without respect to changes in service scope or quality, if the agency believes it can optimize its operations and reduce costs. Such adjustments should only be made if the agency is highly confident of its ability to reduce costs and fully committed to operating with reduced funding levels if the service should continue to be provided by the state. If an agency envisions outsourcing as an option with a long enough time horizon, the agency should assess the feasibility of optimizing its operations so that a future make or buy analysis can compare an optimized state operation against a vendor proposal rather than comparing vendor proposals against a hypothetical optimized state operation.

In assessing whether to optimize its own operations, the state must consider its ability to make the necessary investments in the needed timeframe. Among the factors requiring consideration are whether the agency possesses the authority to add any needed employees or make capital investments and the timeframe required to obtain any additional authority that might be required. Timelines for state hiring processes, procurement processes and leasing processes are other practical considerations.

The state must also consider the organizational, operational and customer impacts of two possible periods of major change coming in close succession. Those are the changes need to optimize internally and the changes associated with outsourcing. Another factor to be considered is the extent to which optimization of the state's operations might provide benefits in service quality.

Under any scenario, the estimate of in-house costs must comprehensively address the state's cost of providing a service. This necessitates capturing all relevant direct costs, agency indirect costs and statewide indirect costs. The *Cost Methodology* provides a detailed itemization of the types of cost elements that need to be considered in calculating direct costs. Elements of direct cost noted in the *Cost Methodology* include the following:

- Salaries and Wages
- Overtime Pay
- Supplies and Materials
- Maintenance and Repair of Buildings
- Rent/Lease of Equipment
- Maintenance and Repair of Equipment
- Other Direct Costs
- Other Compensation
- Fringe Benefits
- Rent/Lease of Buildings
- Telecommunications
- Utilities
- Depreciation of Assets

While the identification of most elements of direct cost may be obvious, there is a need to consider whether a service has direct costs that may be embedded in a part of the agency budget separate from where most of the direct costs of a service are located. Direct costs are costs that are 100 percent attributable to the service being evaluated regardless of the location of these costs in the organization.

Agency indirect costs are costs that support multiple services or functions, including the service or function undergoing outsourcing analysis. This can include agency-wide indirect support or division based indirect support. In either case, it will normally be necessary to use a cost allocation methodology to assign an appropriate share of these costs to the service undergoing the outsourcing analysis. Agencies have considerable discretion in allocating costs internally although outside funding sources, such as the federal government, sometimes place cost allocation requirements on recipients of their funds. The *Cost Methodology* provides a detailed description of several cost allocation methodologies.

Statewide indirect costs include the cost of statewide support and oversight services provided by such agencies as the State Auditor's Office, the Attorney General's Office, the Legislative Budget Board, etc. Agencies are allocated shares of these costs and the service to be potentially outsourced should be allocated a portion of the statewide indirect costs allocated to the agency. The allocation of statewide indirect costs within an agency can be addressed with the same types of allocation options as agency indirect costs, subject to any externally imposed requirements or restrictions.

Finally, confidentiality is an important consideration when developing in-house cost estimates. Prematurely or inappropriately revealing the state cost estimates can compromise the state's ability to obtain the best possible vendor proposals for outsourced services. Unless specifically authorized for disclosure, estimates of in-house costs need to be confidential, whether developed in conjunction with a competitive procurement process or as a preliminary analysis in advance of a possible competitive process.

Determining the Total Cost of Contracting

The total state cost to provide a service or function through outsourcing consists of several elements and involves several considerations. The *Cost Methodology* breaks down these cost elements as shown below.

Contractor Costs	
Plus:	Contract Administration Costs
Plus:	One-Time Conversion Costs
Plus:	Unavoidable State Costs
Plus:	Loss on State Assets
Minus:	Gain on State Assets
Yields:	Total Cost to Contract

Contractor Costs. On the surface, contractor costs may initially appear to be very straightforward because they are the amounts the contractor proposes to charge the state for providing the outsourced service. However, contractor costs need to be the subject of detailed analysis and they can be subject to change through the procurement process and negotiations that may result. Of particular importance is analyzing contractor costs to ensure that they fully and accurately reflect the information and key assumptions of the request for proposals. The contractor's costs need to viably support and align with the contractor's plan for providing the service. It is also critical to ensure that contractor costs don't duplicate costs that may remain with the state.

Contract Administration Costs. These are costs the state will incur in providing a service or function on an outsourced basis that would not be incurred if the state directly provided the service. Such costs include the cost of managing the contract and of monitoring and evaluating the performance of the contractor.

Conversion Costs. One-time conversion costs are the costs the state will incur on a one-time basis in transitioning the service from being directly provided by the state to being provided by a contractor. Examples of conversion costs cited in the *Cost Methodology* include penalties for early lease terminations by the state, costs associated with termination of state employees and costs resulting from the need to sometimes provide financial incentives to employees to stay with the state through the conversion period. In relation to conversion costs, a key issue is how such one-time costs, which are typically front-end costs, should be amortized over the potential contract period.

Unavoidable State Costs. The calculation of unavoidable state costs can be a very complex and important part of the overall cost analysis. This analysis must consider both direct and indirect costs that may remain with the state. Most direct costs to the state will cease with the outsourcing of the service but if any portion of the service remains a state responsibility the associated costs must also remain as costs to the state.

Often a more complex analysis is involved in determining whether outsourcing a service truly reduces the state's indirect costs. The amount of reduction in the state's indirect costs increases when the service being outsourced represents a significant portion of the agency's operations, FTEs and cost structure. A key to the analysis is whether it is possible to identify a discrete component of an indirect support cost that can be associated with the outsourced service. If that is possible that cost can then be eliminated from the agency cost structure. In some instances, the indirect cost of supporting an outsourced service cannot be separated from the costs of supporting other services that are not being outsourced.

In assessing costs that remain with the state under an outsourcing scenario, it is also necessary to capture any costs, direct or indirect, that may shift to a different part of the contracting agency when outsourcing takes effect. This can occur when a service or function is outsourced in most respects, but with those sub-processes or tasks that remain with the agency being assigned to organizational units or employees that previously did not perform those tasks.

Gains and Losses on State Assets. Another potentially complex area of analysis in determining the total cost of outsourcing involves the treatment of assets belonging to the state. The state may have an opportunity to financially benefit from the sale of state assets, such as equipment, vehicles, land or buildings, when outsourcing a service. The state may also have the opportunity to avoid significant additional capital investments. When the state can benefit by reducing its investment in the capital assets needed to provide a service this needs to be factored into the cost comparison as a reduction in the cost of outsourcing. A determination then needs to be made as to how to amortize these financial benefits over the term of the contract.

Several scenarios can arise where the state is faced with a loss in terms of not being able to recover the residual value of an asset. If, for example, the state has recently invested in a software system that is no longer needed for an outsourced service, the software system in all probability cannot be sold. If there are continuing payments needed on that system, those costs would need to be included both in the in-house model and the outsourced model. If the software system were fully paid for, the fact that the state may not have fully realized the intended benefit of its investment in the system does not suggest that a cost factor should be specifically added to either the in-house or outsourcing scenarios in looking to the future. The state's past investment in the system could still have a bearing on the analysis, however, if it allowed the state to reduce future costs while the contractor might have to include costs needed to create the functionality of the system the state already possesses.

An important additional consideration exists if the service to be outsourced generates a revenue stream that is dedicated to paying off debts associated with capital investments for that service. In such a situation, a debt service cost may have to be added to the cost of the outsourcing model just as it would have to be included as a cost under the in-house model.

Outsourcing projects involving substantial state investments in real estate, buildings, equipment or vehicles require additional analysis on the front end. The state should seek to minimize the chance that the cost structure of a contractor will include new investments that duplicate the functionality of state investments that have significant remaining value. This may involve including information in the RFP outlining conditions under which the state is willing to allow a contractor to utilize infrastructure resulting from past state investments.

Cost Savings and the Outsourcing Decision

If the total in-house costs exceed the total costs to outsource the option of outsourcing will produce a net-cost savings for the state. In some instances, the calculation of net-cost savings can be determined by looking only at costs in the budget of the agency administering the service being reviewed for outsourcing. In other cases, however, it may be appropriate or required to also consider any savings outsourcing would produce in the funding requirements of other state agencies. This most commonly might involve savings in fringe benefit costs appropriated to other agencies, such as the Employees Retirement System.

Usually an outsourcing decision will be based on weighing several factors including the estimated cost savings. Other factors could include; the overall quality of the vendor proposal, the quality of the vendor's proposed services, the qualifications of the vendor, and the risks and potential negative impacts if outsourcing proves unsuccessful.

In some instances there may also be specific external direction or mandates regarding the basis for the outsourcing decision. External direction and mandates regarding outsourcing decisions can take various forms ranging from requiring a specified minimum percentage of cost savings to placing the primary focus of the decision on factors other than cost, such as quality of services. Even when other factors receive primary emphasis, it is still important to thoroughly review and evaluate costs and savings to ensure that the state receives outsourced services for the best possible price and establishes a solid and well understood financial relationship with the vendor selected.

It should also be noted that, in some instances, the estimate of cost savings reached through the steps described above might only be an initial estimate that is not firm enough to provide a full or even a partial basis for an outsourcing decision. This situation is most likely to arise when consideration is being given to outsourcing a very large and complex function or service. In these situations, obtaining definitive and complete information on costs and savings, as well as other aspects of the proposal, may require a negotiation process with at least one vendor.

The Importance of Documentation

Outsourcing projects often generate widespread and sometimes intense interest. This interest can come from affected employees, customers or clients of the service, advocacy groups, interested vendors, oversight entities and state offices and officials. Consequently, it is especially important throughout an outsourcing project to keep files and records that document the processes, assumptions and analyses that led to the final outcome of the project. Thorough documentation also helps to provide a basis for internal review of key aspects of the process and serves to reinforce the quality of the outsourcing project.

Inquiries

Inquiries regarding the content of this circular should be directed to Bill Campbell, Associate Commissioner for Planning and Project Management at HHSC, at (512) 487-3325 or by e-mail at Bill.Campbell@hhsc.state.tx.us.