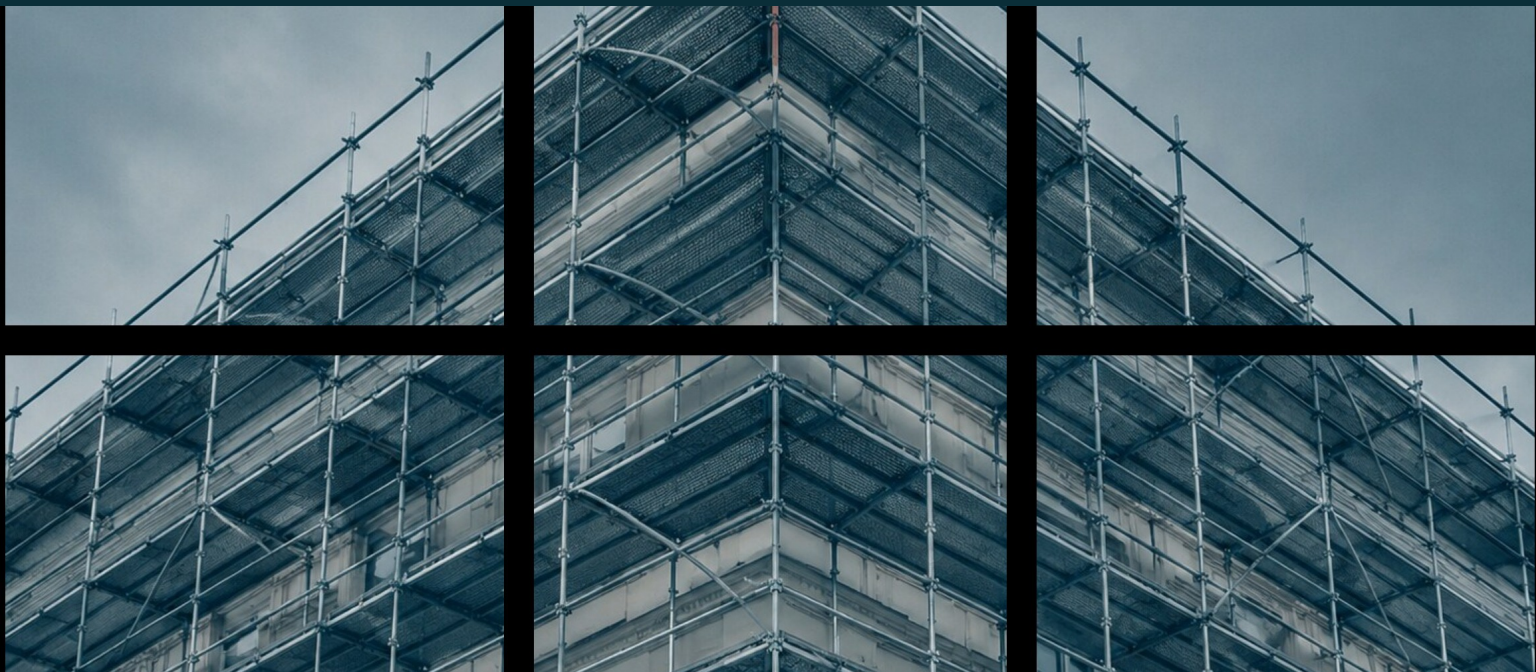


BEYOND THE RATE CARD

Offshore Delivery and the Illusion of Cost Arbitrage

A Practitioner's Perspective on the Hidden Economics of Outsourced Transformation



Giovanni Leonardi

February 2005

Offshore Delivery and the Illusion of Cost Arbitrage

Transformation · No. 45

Originally written February 2005 | Re-edited and re-rendered for the WhereBeyond Edition, 2025

“The business case was built on the rate card, but the real cost was written in the programme plan — in rework cycles, in specification overhead, in the slow erosion of knowledge that no contract clause could prevent.”

1. The Promise and the Arithmetic

The arithmetic of offshore delivery is seductive in its simplicity. A developer in London costs the organisation, fully loaded, somewhere between sixty and ninety thousand pounds a year. A developer in Bangalore or Hyderabad, engaged through one of the major outsourcing providers, costs between twelve and twenty thousand. The gap is so large that even generous allowances for management overhead and productivity differentials leave a compelling financial case. On paper, the savings are undeniable.

The difficulty is that the savings exist on paper and substantially less reliably in practice. After three years of watching organisations pursue offshore delivery at scale, the pattern I have observed is consistent: the rate card savings are real, but they are consumed — partially, sometimes wholly — by costs that the business case did not capture and the governance model was not designed to manage.

This is not an argument against offshore delivery. It is an argument against the illusion that cost arbitrage is the primary benefit, and against the business cases that treat a rate card comparison as a sufficient basis for a transformation decision.

2. Where the Savings Go

The business case was built on the rate card, but the real cost was written in the programme plan — in rework cycles, in specification overhead, in the slow erosion of knowledge that no contract clause could prevent.

The erosion follows a recognisable pattern, and it is worth tracing in detail because it explains why the financial outcomes consistently disappoint without any single cause being large enough to trigger an alarm.

Specification overhead. An internal team absorbs context continuously. They attend meetings, overhear conversations, understand the organisational politics that shape requirements, and apply tacit knowledge that never appears in any document. An offshore team has none of this. Every requirement must be explicitly specified, every assumption documented, every interface defined. The effort required to produce specifications of sufficient precision for offshore consumption is substantial — and it falls on the retained team, whose capacity has typically been reduced as part of the outsourcing business case.

The result is a choice between two unsatisfactory outcomes: either the retained team spends a disproportionate share of its time writing specifications rather than doing

higher-value work, or the specifications are incomplete and the deliverables miss the mark. In practice, most organisations oscillate between both.

The rework cycle. When deliverables miss the mark — and they do, routinely, not through incompetence but through the inherent difficulty of communicating complex requirements across organisational, cultural, and temporal boundaries — the cost of correction is higher than it would have been with an internal team. The feedback loop is longer: a misunderstanding that an internal developer would resolve in a corridor conversation takes a day or more to clarify across time zones and contractual structures. Each iteration of rework carries the full round-trip cost of specification, development, review, and correction.

Management overhead. The outsourcing business case typically assumes that the retained management structure can oversee the offshore delivery with modest additional investment. The reality is different. Managing an offshore relationship requires dedicated programme management, vendor relationship management, quality assurance, and escalation management that did not previously exist. These roles are filled by experienced — and therefore expensive — people, and their cost substantially reduces the net saving.

Knowledge haemorrhage. This is the slowest and most damaging cost. As work moves offshore, the institutional knowledge of how systems work, why they were designed the way they were, and what the undocumented dependencies are gradually leaves the retained organisation. After eighteen months to two years, the retained team is managing a delivery relationship for systems they no longer deeply understand. This creates a dependency that shifts leverage towards the provider and makes any future sourcing decision — including the decision to bring work back in-house — substantially more difficult and expensive.

3. The Honest Arithmetic

When these costs are accounted for honestly, the picture changes considerably. The pattern I have observed across multiple engagements is that organisations targeting 40 per cent cost savings from offshore delivery typically achieve net savings of 15 to 25 per cent in the first two years, declining to 10 to 15 per cent thereafter as contract renewals reflect the provider's increased leverage and the cost of managing an increasingly complex delivery model.

These are still savings. They are not trivial. But they are dramatically less than what was promised, and they come with strategic costs — reduced agility, knowledge dependency, diminished innovation capacity — that the business case never quantified.

The question organisations should be asking is not whether offshore delivery is cheaper — it usually is, at the margin — but whether the net saving, once all costs are honestly accounted for, is sufficient to justify the strategic trade-offs involved. In most cases I have seen, the answer is considerably less clear than the business case suggested.

4. What the Business Case Should Have Included

A more honest business case for offshore delivery would include five elements that are routinely absent.

- Specification costs — the additional effort required to produce specifications of offshore quality, estimated realistically based on comparable transitions rather than optimistic assumptions.
- Rework allowance — a realistic provision for the rework cycle, based on observed defect rates in offshore delivery rather than the contracted service levels that rarely reflect operational reality.
- Management overhead — the full cost of the retained management structure required to run the relationship, including programme management, quality assurance, and vendor management.
- Knowledge transition and retention — the cost of knowledge transfer, the ongoing cost of maintaining sufficient internal understanding to make informed decisions, and the risk-adjusted cost of knowledge loss.
- Flexibility premium — an honest assessment of the cost of reduced strategic agility: slower response to changing requirements, higher cost of change through contractual mechanisms, and the opportunity cost of a delivery model optimised for predictability rather than responsiveness.

Most business cases include none of these. Those that do typically underestimate them. The result is a decision made on incomplete information, which is precisely how so many organisations have found themselves committed to offshore relationships that deliver less than they expected and cost more to manage than they anticipated.

5. The Real Case for Offshore Delivery

None of this means offshore delivery is wrong. It means the case for it needs to be made honestly, on the basis of what it actually delivers rather than what a rate card comparison promises.

The genuine advantages of offshore delivery are real but different from the ones typically cited. Scale flexibility — the ability to ramp capacity up and down more rapidly than internal recruitment allows — is genuinely valuable for organisations with variable demand. Access to skills that are scarce domestically, particularly in newer technology areas, is a legitimate driver. The discipline of specification — the rigour required to communicate requirements across a boundary — can, when well managed, improve the quality of requirements and reduce ambiguity. These are operational benefits, not just financial ones, and they deserve to be weighed on their own merits rather than bundled into a cost arbitrage story that does not withstand scrutiny.

The organisations that are getting the most value from offshore delivery are, in my experience, those that approached it as an operating model decision rather than a cost reduction exercise. They invested in the management capability to run the relationship well. They retained enough internal knowledge to remain intelligent clients. And they were honest with themselves — and with their boards — about what the realistic savings would be.

6. A Practitioner's Conclusion

The outsourcing wave is reshaping the technology landscape in ways that will take years to fully play out. Some of those changes will prove beneficial. Others will prove costly. The organisations that will fare best are those that make their decisions with clear eyes rather than compelling spreadsheets.

The illusion of cost arbitrage is exactly that: an illusion. Not because the savings do not exist, but because they are smaller than promised, harder to sustain than assumed, and accompanied by strategic costs that no rate card comparison can capture. The sooner organisations stop treating the rate card as the answer and start treating it as the beginning of the question, the better their outsourcing decisions — and their transformation outcomes — will be.