Available online at www.sciencedirect.com
ScienceDirect
Omega 36 (2008) 941–949
omega
The International Journal of Management Science
www.elsevier.com/locate/omega

BOCOG's outsourcing contracts: The vendor's perspective☆

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Received 12 December 2006; accepted 30 May 2007
Available online 5 June 2007

Abstract

To date, most research on outsourcing is modeled from the client's perspective. In this paper, we approach the Beijing Organizing Committee for the Games of the XXIX Olympiad (BOCOG) outsourcing contracts from the vendors' perspective. Since a vendor always has the option to accept or not accept an outsourcing contract, we use the theory of options to analyze the vendor's decision making, i.e., the trigger point, which coincides with the optimal profit level, of the vendor's decision to pursue an outsourcing contract. Numerical examples are presented to demonstrate the model and its potential benefits for vendors' decision making.

Keywords: Decision making/process; Bidding; Optimization

1. Introduction

In 2008, Beijing is expected to welcome more than 500,000 overseas and 1 million domestic visitors. This 2-week celebration of sports requires years of planning and financing. Beijing was awarded the Olympic Games in 2001, giving them 7 years to prepare for this massive project.

The Olympic Games represents one of the most outsourced of any sporting event. After the announcement of the award, the Beijing Organizing Committee for the Games of the XXIX Olympiad (BOCOG) immediately set into motion the process of securing suppliers for all concessions and hospitality services. These include:

- building materials, products, systems and technologies;
- facility design and operations management;
- finance and insurance services;
- environmental protection technologies;
- event security and security related products;
- transportation and logistics;
- ticket management and sales consultancy;
- health consultancies and services;
- catering consultancies and services;
- tourism and entertainment services.

Olympic outsourcing is an advanced form of a project portfolio management system. Project portfolios include three types of projects: compliance, operational, and strategic [1]. Compliance projects are those required to meet regulatory conditions. In the Olympic Games, this would include environmental preparations

☆ This manuscript was processed by A.E. Zhu.

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0305-0483/$ - see front matter
doi:10.1016/j.omega.2007.05.004

that have to be accommodated—for example, outsourcing of janitorial services. Operational projects would involve the scheduling, logistics, and execution of the events—the actual daily work packages that have to be accomplished. One example would be the outsourcing of the programs at each event. A vendor is selected to print, produce, and distribute the programs at each site. The strategic projects are those that have long-term significance for both China and the Olympic Games. China sees the Games as an opportunity to promote its modernity and culture to the world. The Games wants to continue as an operating entity of significance.

Projects in a portfolio are of both financial and nonfinancial criteria. Outsourcing decisions fits within the financial criteria, and the decision process is critical in producing a profitable Olympic Games. Until the 1984 Olympic Games, most cities viewed the Olympics as public relations extravaganzas. However, the Games in Los Angeles proved that a profit could be made.

But, who makes the profit? Do vendors share equally in the financial success of the Olympic Games? While the client's outsourcing decisions (BOCOG, in this instance) and the client–vendor relationships have been examined in the current literature, the vendor's perspective has hardly been explored. In fact, there are significant risks born on the vendor who accepts an outsourcing contract. Those include capital reinvestment, realignment of capacity and resources, dedication of its existing capacity to provide the outsourcing service and forgoing investment opportunities from other competing projects or contracts. After interviewing several of BOCOG's vendors, we find that there are three main considerations for vendor risk: pressure of bidding process, uncertainty of baselines, uncertainty of costs and pricing.

1.1. Pressure of bidding process

Outsourcing deals are often secured as the result of sealed bid auctions. In its marketing plan, BOCOG announced that "each candidate should make its offer competitive in price, which is one of the key criteria for selecting sponsors." Based on established criteria, BOCOG invites a shortlist of vendors to an intense round of negotiations in which BOCOG seeks to extract the desired service levels at the lowest prices. To beat rivals in such an auction, a potential vendor may provide bids calculated with marginal costs, leaving a wafer thin buffer upon which it can profit.

1.2. Uncertainty of baselines

The baselines of an outsourcing contract are the specifics of services and dimensions. Usually, vendors themselves have more information or knowledge about the outsourced product or service than clients do. Thus, for clients, it is difficult to design a complete outsourcing contract in the presence of information asymmetry and lack of special knowledge. The client's inability to define exact baseline requirements, subsequent unreasonable expectations that additional or undocumented services would be provided without additional costs, together with the potential rise of production or service costs due to external uncertainty, can cause client–vendor relationships to deteriorate. In reality, additional vendor costs should be recovered through charging excess fees to the client. However, facing the scope creep of outsourcing expenses, the dissatisfied client may terminate the contract and switch to a new vendor.

1.3. Uncertainty of costs and pricing

To limit the risk of increasing prices and extra charges, BOCOG prefers to sign fixed price outsourcing contracts, through which BOCOG pays fixed, all-inclusive fees for predetermined accounts for all services offered under an outsourcing agreement. While such a contract can avoid the scope creep of the vendor's overcharges and makes BOCOG's budget planning much easier, it may depart from the true costs or market values, influenced by reasons such as scarcity of resources, economic cycles, fast-changing technology or the altering scale or scope of economies, that exist during a contract's duration and affect a vendor's operating costs and market position.

For a vendor who is facing the above uncertainties, the real options approach may be appropriate to their decision making, since this model is particularly applicable when there are elements of high risk emanating from more than one source, managerial flexibility, and information asymmetry. A real option is defined as the *right* (but not the obligation) to acquire the present value of an expected cash flow by making an investment. In the outsourcing setting, the vendor has the option to either undertake or reject the contract. This research aims to provide practical guidelines for a vendor's decision making process leading up to this point.

The remainder of this paper is structured as follows: Section 2 briefly reviews the literature on vendor's outsourcing decisions. Section 3 sets up the relationship between the vendor's decision making and the theory