

Sourcing & Vendor Relationships Advisory Service
Executive Update Vol. 9, No. 1

Update

Benchmarking Your Outsourcing Contract: Approaches and Opportunities

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Benchmarking of outsourcing contracts has recently become a highly desired practice by client organizations, but it is often poorly executed. It can be a difficult and expensive process regardless of how services are sourced, internally or externally. This first *Executive Update* of a two-part series walks you through a few of the issues, including approach options and opportunities to consider when thinking about benchmarking as part of an outsourcing decision or deal.

VARIOUS APPROACHES

The approach can be as economical as you can afford in time and/or money. There are three fundamental approaches to benchmarking:

1. Independent consultant
2. Partner organizations
3. Your own database of competing service providers

First is the use of independent consultants. This is a popular approach — but also the most expensive. There are a number of benchmarking consultants from mature markets, ones that have been operating reasonably long and have commoditized goods and services. The key to getting value for money will be how well you scope the benchmarking exercise. There are two additional special considerations when using consultants: (1) whether the consultant must disclose individual data sets, as opposed to aggregate or average numbers, to your organization as well as the service provider (albeit keeping the names of the organizations confidential),

and (2) whether fees include any dispute-resolution processes resulting from the benchmarking exercises. If your agreement with the consultant does not mention either of these two items, you will not have access to the data, and you will have to pay extra if your service provider disputes any of the findings, and the consultant needs to be involved.

Because consultants are the most expensive option, many organizations choose a few select clients with which they will partner (the second approach). Your goal under this approach is to partner with client organizations from the same, or similar, industries as yours. But, if this is not possible, a reasonably similar scale and scope of a contract is common. While there will be fewer data points than in a consultant's database, the data you collect is likely to be more meaningful to you. It allows your team to do a detailed apples-to-apples comparison as well as investigate detailed explanations of differences and solutions.

CASE STUDY: LACK OF MEANINGFUL BENCHMARKS

A power company's CIO had believed benchmarks were readily available and simple to apply; it was merely a matter of finding a consultant. He asked the consultants who were working at the company at the time if they had benchmarks and what those would cost. Happy with the answer, the CIO set the benchmarking project in motion.

Upon receipt of the voluminous report, the CIO struggled to find any meaningful information. When he queried attributes of source data (age, industry, location, etc.) and the method of scope alignment, he was told all that was confidential. Having no way of knowing whether the benchmarks represented current data in his industry, with comparable scope, let alone whether any of the benchmarks were from international or local sources, he threw the report out. But he still had to pay \$100,000 for it. Here, the benchmarking yielded nothing but a strong desire not to go through it again.

Under the last approach, some organizations create their own database through the use of supplier panels or multiple suppliers for the same services. You typically see this in applications development where it is not unusual to see on a panel dozens, if not hundreds, of developers. By having a reasonable number of service providers compete regularly for various contracts or work orders over a defined period, you are in effect continually benchmarking each contract.

SCOPING

Expecting good data as an *inherent* result of a benchmarking exercise is a common gaffe made by first-timers. To make sure your benchmarking exercise delivers the expected degree of meaningful information, and particularly to manage an independent consultant as your benchmarking agent, the most important aspect is to get the scope of the data to fit your organization best. Defining what you believe would be an apples-to-apples comparison is the only way you can be assured of even getting something fruit-related.

For example:

- **How old can the data be?** If you do not specify this, the data will be very old, indeed.
- **What geographic regions can the data be from?** If you do not specify this, do not make any assumptions about what country the information was sourced from, only that it may not be the countries where you operate.
- **Will it be tax inclusive or exclusive?** Exclusive is a better approach to normalizing data from other countries and/or states.
- **Can it be insourced or only outsourced operations?** If you do not specify this, the exercise could result in comparing your contract to internal operations of other organizations.
- **What industry can the data be from?** If you do not specify this, rest assured little of the data will be from your industry.

- **How large and small can the organizations be?** If you do not specify this, the data may come from very small to very large organizations, which may not be as meaningful to you.

BENCHMARKING THROUGHOUT THE OUTSOURCING LIFECYCLE

The outsourcing lifecycle¹ consists of four phases and nine building blocks (see Figure 1), representing the best practices in forming and managing outsourcing arrangements based on research with 107 organizations [3].

During the architect phase, after you have a bit of an idea about what you may consider outsourcing, a reasonable understanding of current market prices and service levels is one of the key steps in the first building block: investigate. This is invaluable information for your own piece of mind, but also for when dealing with the supplier's pitch on service delivery. Being fact-based is vital; it enables you to sit down and calculate, rather than have to negotiate in an ill-informed way. Most organizations do this as part of their decision regarding whether to go to market very early in the outsourcing lifecycle (see Figure 2) [2]. And the focus is not just on cost, but also on service levels, which is an abridged value-for-money assessment.

While most organizations perform some form of benchmarking as part of the letting of a contract, as Figure 2 shows, prudent contract management continues this process throughout the life of the agreement in the operate phase.

Studies in Australia have shown a few trends regarding benchmarking after the contract has been signed. First, there is a 50:50 split between those organizations that have benchmarked during the operate phase.

For those that benchmark, it tends to be performed as a one-time event, often at the end of the contract, or annually (see Figure 3). Second, the approach taken tends to be through the use of a partner organization — another organization bearing enough similarities to the contracted services to allow for meaningful comparisons (see Figure 4). Interestingly, 10% used the

¹For more on the outsourcing lifecycle, see [1].

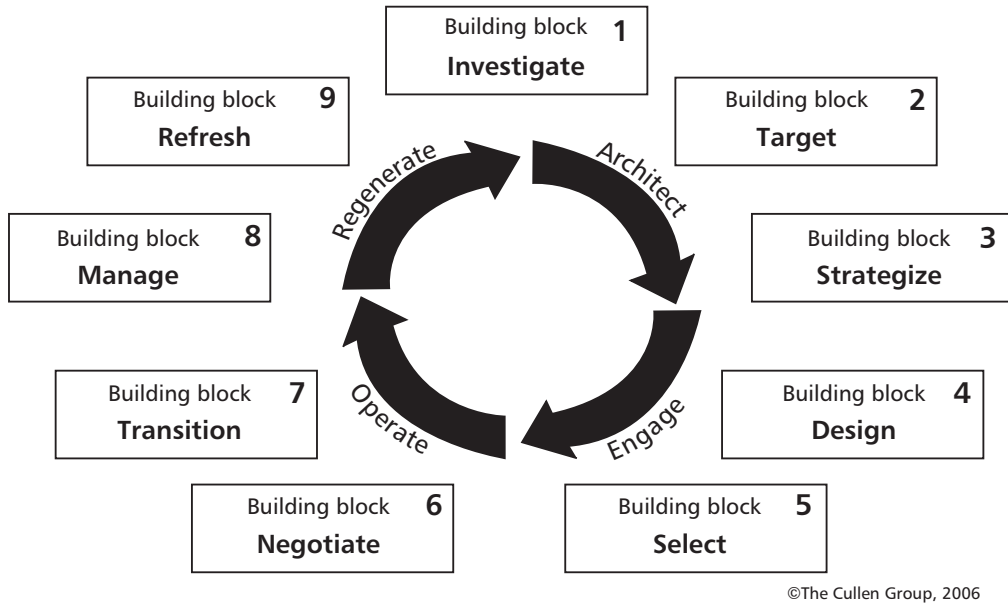


Figure 1 — The outsourcing lifecycle [1].

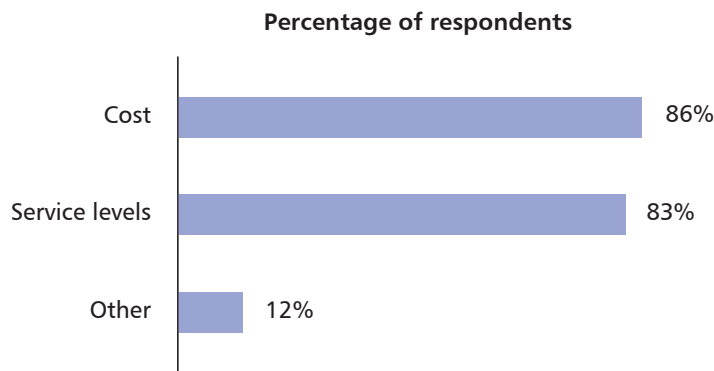


Figure 2 — Benchmarking as part of decision process (150 respondents) [2].

service provider’s other clients for its benchmarking. Organizations that use the service provider’s clients for benchmarking tend to do so because the contract requires the organization to be within a certain percentile range of the service provider’s client base (i.e., top quartile for key performance indicators [KPIs], lower half for costs — or something similar).

Last, while the client funds the majority of benchmarking exercises, the exercise itself is more often a joint effort, as opposed to an effort by one party (see Figure 5).

It is inevitable that the industry, and outsourcing practices in general, will evolve from the time the original arrangement was put in place. The end of any outsourcing contract, the refresh phase, offers the opportunity to

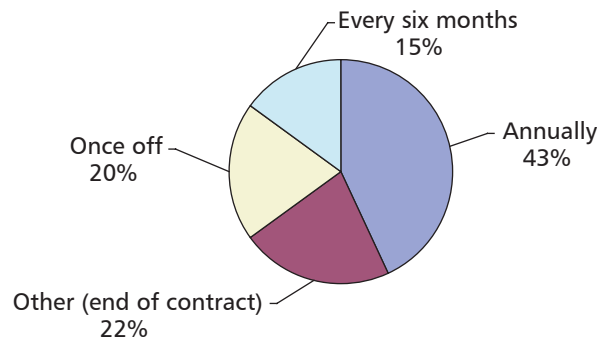


Figure 3 — Frequency of benchmarking (126 respondents) [2].

investigate and adopt evolved practices, particularly if this had not been an ongoing inherent process adopted by the organization’s contract management function.

Accordingly, obtaining current benchmark performance levels and costs against comparative industry standards to determine whether KPIs should be upgraded, and to determine future cost expectations, is very useful at the end of a contract to establish a basis for renegotiation or retendering. You are likely to find that new KPIs have emerged in the market (or better ways of measuring the old ones), that the industry standards have been raised, or that prices have gone down (for most things that are not labor-intensive and cannot be offshored).

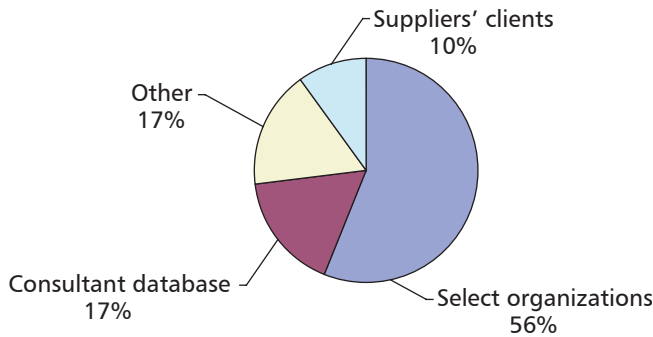


Figure 4 — Source of benchmarks. (75 respondents) [2].

CONCLUSION

Benchmarking allows you to demonstrate to stakeholders that you are getting value for money. Or, if you are not, it provides targets, and possibly techniques, that can improve the deal’s value-for-money equation. Regular benchmarking throughout the outsourcing lifecycle makes it a normal contract management technique, keeping you abreast of the market, and drives continuous improvement.

Part II will provide you with examples of benchmarking clauses and the experiences of those who worked with those clauses.

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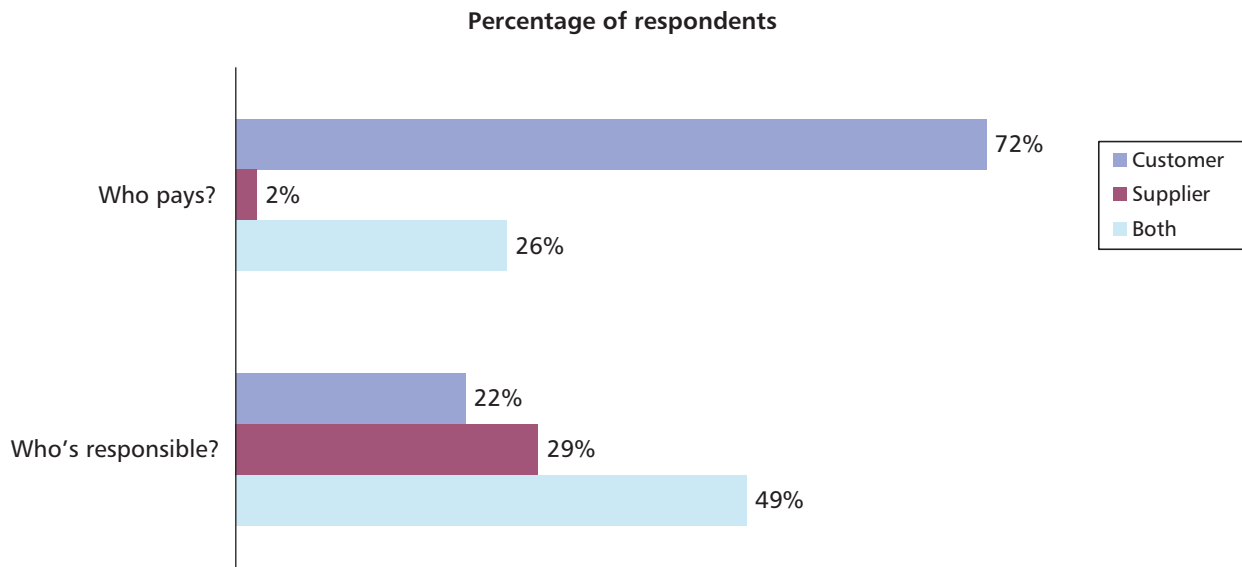
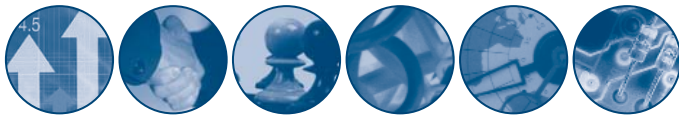


Figure 5 — Benchmark funding and responsibility (184 respondents) [2].

organization offering consulting, training, and methodologies regarding commercial agreements. Dr. Cullen was a former national partner at Deloitte in Australia, where she ran the outsourcing consulting division, and she received her PhD from Melbourne University in the field of outsourcing. She has consulted to 110 private- and public-sector organizations, spanning 51 countries, in more than 130 outsourcing projects with contract values up to \$1.5 billion per year.

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Update

Benchmarking Your Outsourcing Contract: Clauses

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Benchmarking of outsourcing contracts has recently become a highly desired practice by client organizations, but it is often poorly executed. It can be a difficult and expensive process regardless of how services are sourced, internally or externally. In Part I of this two-part *Executive Update* series (Vol. 9, No. 4), we examined a few of the issues, including approach options and opportunities to consider when thinking about benchmarking as part of an outsourcing decision or deal. Here in Part II, we provide examples of benchmarking clauses and the experiences of those who work with such clauses.

The benchmarking provisions within outsourcing contracts are often quickly agreed to without much forethought. However, once a benchmarking exercise has been conducted, what to do with the results usually becomes hotly disputed.

Take the example below. It appears to be a straightforward contractual provision. The parties are to agree on the consultant, the terms of reference, and share costs. If the study finds that the current market prices are lower than those being levied, the charges are to be reduced to the market price.

SAMPLE CONTRACT

1. Benchmarking Study

1.1 (**Date of Benchmarking Study**) Within 18 months of the commencement date, a Benchmarking Study will be undertaken on the terms of this clause.

1.2 (**Benchmarking Information**) The Supplier must make sure all information required for the Benchmarking Study is made available and that it gives all reasonable assistance to ensure the success of the Benchmarking Study.

1.3 (**Benchmarking Organization**) The Client will initiate the Benchmarking Study by proposing to the Supplier the name of a suitable organization specializing in such studies. Both parties must agree on the appointment of the organization to undertake the Benchmarking Study.

1.4 (**Terms of Reference**) The benchmarking organization will be provided with terms of reference agreed to between the Client and the Supplier. The terms of reference will include determination of the range of costs associated with the delivery of equivalent services in equivalent technical environments to manufacturing customers in equivalent locations.

1.5 (**Cost**) The Client and the Supplier will meet the cost of the Benchmarking Study in equal shares provided that both parties agree that the cost of the Benchmarking Study is reasonable. The cost of the Benchmarking Study is not included in the Contract Charges.

1.6 (**Adjustment to Contract Charges**) Upon completion of the Benchmarking Study, the Contract Charges will be adjusted as follows:

- (a) If the then-current Contract Charges are outside the lowest price quartile (where the quartile consists of one-quarter of the respondents to the Benchmarking Study), then the Supplier shall commit to reducing the Contract Charges so that they fall within that quartile.
- (b) The adjustment will take effect within three months of completion of the Benchmarking Study.
- (c) Any dispute arising as a result of an adjustment under this clause will be referred to the Dispute Resolution Committee.

DIFFICULTIES WITH CLAUSES

The parties did agree on the consultant, a well-known international benchmarking firm, but that was the

last time they agreed on anything to do with the benchmarking study.

The consultant found that market prices were 20%-35% cheaper, so the client invoked clause 1.6 (Adjustment to Contract Charges) to adjust the contract charges accordingly. The service provider then invoked clause 1.7 (Disputes — not shown in sample) to dispute the findings, claiming that the data was not in accordance with clause 1.4 (Terms of Reference) — that it was not from data regarding “*equivalent* services in an *equivalent* technical environment.” Nor was it from “*manufacturing* customers,” nor in “*equivalent* locations.” The service provider’s interpretation of “*equivalent*” was so narrow that no organization in the consultant’s database qualified.

The parties went to alternative dispute with a mediator. After a lengthy process, the mediator determined in favor of the service provider. The fact that the consultant did not have an “*equivalent*” to this contract was considered irrelevant. There was eventually a happy ending to this case. The client continued with the contract for two years, until its expiry, and then went to retender. It achieved well over the 35% cost savings by packaging the work differently and switching service providers.

The problem with forcing the service provider to meet the benchmarks, as in the above case, is that it tends to be quite a heavy-handed approach. It basically assumes that the service provider is intentionally overcharging and that once evidence is found regarding the “*overcharging*,” the service provider is forced to comply — regardless of the situation that gave rise to the prices in the first place.

For example, below is a case with an extreme situation of higher charges. The client was found to be paying prices for every service far exceeding the market four years after signing, including:

- Desktop and LAN services that were 54% above the market median
- The highest ever encountered per-call price for help desk services, exceeding the median per call by more than 250% and having the most expensive rate in the market by 57%
- Data center services that were 55% above the median when expressed in terms of monthly cost per millions of instructions per minute and 30% above the median when expressed in terms of monthly cost per gigabyte

Why were the costs in this case so high? It is natural to assume that the service provider was gouging the client. But, in reality, some very basic decisions that the client had made affected much more than prices paid. First, the client required that the help desk and data center be on the client’s site and wholly dedicated to the client. Second, the client made the service provider buy its IT assets at book value rather than the significantly lower market value. This cost, plus the financing cost, was then amortized into the price over the entire term of the contract. Third, the contract fixed future technology acquisition costs at the then-current costs when the contract was formed. During the five-year term, the price/performance ratio in the industry dramatically improved — but the client was stuck with five-year-old prices (regardless of what the service provider actually paid). Fourth, the entire invoice amount was “*at risk*” for service-level penalties. This had the effect of ensuring that service levels were far below industry norms, due to the severe risk put on the service provider. For example, the contract held the help desk only to 40% of calls to be resolved on first contact with help desk, when the industry norm is 70%.

ACHIEVING BETTER RESULTS

Merely stating that a service provider has to meet a benchmark does not mean that it can. In the above case, significant reengineering would have been required; moving the help desk and data center offsite would have been just the start. For this reason, better results can be achieved when the benchmarking exercise is conducted in order to formulate an improvement plan whereby the parties are able to work through why costs are higher, or services are lower than the market, and work together to implement solutions progressively.

An example of such a clause is shown next. Note that clause 1.4 requires an improvement plan that is to be implemented by an agreed-upon date. In a worst-case scenario, if the plan cannot be agreed to, the client

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then has the right to terminate in clause 1.5. Those who have used a clause like the one below have never had to invoke termination:

1. Benchmarking

1.1 (**Exercises**) The Client may commission, or itself conduct, benchmarking exercises for all or part of the Services throughout the Term.

1.2 (**Terms of Reference**) The Client shall provide the Contractor with the terms of reference regarding any benchmarking exercises that shall include the scope of the exercise and the benchmarking sample to be used.

1.3 (**Duty to Assist**) The Contractor must comply with any request and provide full cooperation, including access to relevant records and personnel, to the Client or its nominee in relation to any benchmarking exercised insofar as it pertains to the Services, this Contract, or the Client.

1.4 (**Results**) The results, but not the underlying data, of the benchmarking exercise will be summarized and presented to the Contractor. If the Contract costs are above the benchmark costs, or Contract KPIs are lower than the benchmark KPIs, the Contractor shall, if requested by the Client:

- (a) Prepare an improvement plan to meet, or exceed, the benchmarks that meet the satisfaction of the Client.
- (b) Implement the improvement plan by the agreed deadline.

1.5 (**No Agreement**) If an improvement plan cannot be agreed to, the Client may terminate this Contract.

1.6 (**Costs**) Each party shall bear its own costs with regard to any benchmarking exercises and implementation of the results. External fees in conjunction with benchmarking exercises shall be borne by the Client.

CONCLUSION

Benchmarking can work very well if it is done in the spirit of goodwill, with the goal of continual improvement. Give the service provider time to reengineer to get there, and be prepared to make some concessions yourself. Otherwise, disputes are inevitable.

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