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The Issue: *Benchmarking Outsourcing Contracts*

Business process outsourcing describes the practice of contracting out specific, generally non-core business functions to external suppliers and service providers who can demonstrably perform these functions more efficiently and economically than the contracting company. A wide and growing array of processes, including accounting, personnel management and customer care are increasingly the focus of outsourcing contracts. But by far the most frequently outsourced business process is the management of information and communications technology services. The research firm Meta Group estimates that outsourcing in the North American marketplace is growing rapidly at a rate of between 10 and 15 per cent annually. Canadian adoption of outsourcing strategies lags that of the United States, but even here outsourcing of ICT services is relatively commonplace. A recent study produced by the Centre for Outsourcing Research and Education found that, particularly among larger Canadian companies, outsourcing as a business practice is maturing with some companies reporting over 100 outsourcing agreements.¹

As experience with outsourcing grows so does the list of reasons for deploying outsource strategies. Companies may seek to focus on core business activities by outsourcing administrative and other non-core business services. Some outsource strategies are driven by quality improvement or by a desire to access a set of capabilities that the organization may not have. Whatever the strategic implications of an outsourcing contract, cost management is always an issue. In many cases, it is the central issue.

Outsourcing contracts are generally complex and span many years (anywhere from five to fifteen years and beyond). Customers will seek some reassurance that a fair market price negotiated at

the beginning of a contract will still be fair at the mid point and at the end.

For their part, vendors are concerned about the profitability of the whole contract. Initial bid costs, marketing and the costs associated with absorption of customer personnel into the contract are generally spread over the life of the contract. As one analyst points out, "Typically, (vendors) earn their money beginning in the second or third year, after transition is complete. Later if all goes well, margins will grow so that average returns for the whole contract term are acceptable ... Just when the supplier looks forward to earning the anticipated return, the customer will press for cuts."²



Increasingly, the use of benchmarking is emerging as a means of addressing this dynamic tension between customer and vendor. Benchmarking is conducted through a study in which the various components of a contract—price, service levels and terms and conditions—are compared to those of peer companies. Just as an independent assessment of the value of a piece of real estate is conducted by a third party outside the realtor/home buyer relationship, benchmarking studies are conducted by consulting companies (who generally speaking have established their expertise in this area) who do not compete with the outsourcing vendor. A

¹ Optimizing Value from Outsourcing, CORE, November 2006, page 5.

² "Price Protection through Benchmarking," Baker and McKenzie, September 2006, pages 1-2.

mid-contract benchmarking study is generally agreed to as part of the contractual process, with both parties identifying and accepting the benchmarking firm. Alternately, a number of customers are resorting to the unilateral imposition of benchmarking clauses as a means of controlling and adjusting costs over the life of a contract. While this seems like prudent practice, the reflexive insistence on benchmarking can have unforeseen implications.

A number of consulting firms have established a measure of credibility in providing benchmarking studies. Nevertheless, the benchmarking practice is still relatively immature and even with the best of intentions by all parties is fraught with complexity. This is compounded by the prevailing expectation that benchmarking will illuminate price disparities that customers will use to justify downward adjustments upon the supplier. Customers will frequently insist that the contractor achieve bottom quartile or even bottom decile price comparisons as a result of the benchmarking study. So there is considerable risk for vendors who, having incurred all the costs of sale and contract as well as the transitional costs that occur at the front end of a contract, must face a benchmarking process to reduce margins just when a contract is becoming profitable. Vendors are justifiably leery of benchmarking, and given the current state of play in the practice they have good cause.

To begin with, outsourcing contracts are inherently complex. They are basically delivering the output of a corporate department. Human teams are at work with variable protocols for operations. There is no cookie-cutter approach for outsourcing. Outsourcing contracts are not commodities. Measuring inputs and outputs is challenging.

Unlike a home or property appraisal which can be derived from a broad array of readily available data, benchmarking requires expertise beyond pure numeric comparisons. Benchmarking specialists must have a strong grasp of contract pricing, contract terms and technology solutions. And they must be flexible enough to apply this expertise across a matrix of key variables. At least five variables are fundamental to achieving a fair comparison. This list gives a compelling picture of how challenging a task benchmarking is:

- Scope: Costs must be added or removed from the reference costs to match the services and technology provided by the customer.
- Volumes: The target price should factor for economies of scale, and any difference in size between the clients services and the reference costs.

- Service Levels: Reference costs must be selected from organizations that aim for and meet similar levels of service and quality.
- Geography: The calculations must allow for cases where the outsourcer is delivering in a location with very different labour costs to the reference costs, or where the services are delivered in many locations rather than a few.
- Client Restrictions: The calculations should add or remove costs if the outsourcer is restricted by the client from implementing cost-saving measures adopted by the best-performing in-house organizations.³

Obviously a benchmarking study must allow for a higher level of interpretation than more familiar commodity price audits. Add to this the simple shortage of accessible data (contract disclosure, even in the interests of best practice is not something all organizations are comfortable with) and the fact benchmark peers are not chosen randomly but selected by the benchmarking firm and it becomes clear that current practice benchmarking cannot be statistically rigorous.

The rudimentary state of benchmarking leads to widely varying results. Vendors report seeing exponentially disparate estimates of comparable costs in benchmarking studies. Sophisticated customers are coming to view them as imprecise indicators that may contribute to, rather than define, a larger picture of contract performance. The CORE study previously cited found that “while benchmarking is widely used in all types of outsourcing relationships, it is considered to be of moderate value...the great majority of respondents...saw benchmarking as being effective only some of the time.”⁴

Vendors are developing their own strategies for mitigating the effects of benchmarking studies or avoiding them altogether. For example, some vendors report a strategic shift to the pursuit of shorter term contracts to avoid the need for a mid-contract review. Others are actively advocating for a more strategic, value-focused assessment of outcomes.

While the rudimentary nature of benchmarks is clearly a concern for vendors, it should be a concern for customers as well. Outsourcing involves the release of control of a business operation that can be as sensitive as tax payment or personnel management to an outside party. This entails a high degree of trust and a shared commitment to succeed between the customer and

³ “Fair Market Price: Using Benchmarks to Establish Rates for Outsourcing Services,” Compass Consulting, page 8.

the vendor. An ill-conceived benchmarking clause can seriously damage this relationship and do more damage than a price adjustment could ever warrant.

Achieving performance outcomes, and being able to demonstrate that a supplier has achieved them are important in any contractual process. It is in no vendor's interest to duck effective measurement of outcomes. But the jury is still out on whether benchmarking studies can provide an effective measure or simply contribute one of a number of data inputs that build a more comprehensive picture of the achievement of outcomes and the success of an outsourcing relationship.

Given the rudimentary state of benchmarking, best practice calls for a comprehensive understanding of the central importance of the relationship between vendor and customer and a recognition that a healthy relationship may have a more positive impact on contract outcomes than a few points squeezed off the vendors margin. Customers are well advised to acquaint themselves with the limitations of benchmarking studies before placing a business critical relationship at risk through the use of impractical benchmarking expectations. Organizations such as the Centre for Outsourcing Research and Education offer excellent resources to advance the art of benchmarking and a customer's knowledge of what it can and cannot do.



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