The PRICING ADVISOR
A Professional Pricing Society Publication
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How Best to Compare Price and Performance for IT Services

Companies assessing whether to outsource IT services should make careful use of cost and price benchmarking studies. Authors Uwe Helmer and Gary Tovey, both Vice Presidents with IT Advisory Services for PricewaterhouseCoopers LLP, point out the potential pitfalls of these tools and offer a blueprint for applying them most effectively. For more information, please contact: uwe.helmer@ca.pwc.com or gary.tovey@ca.pwc.com.

When we're driving and notice a police cruiser in the rearview mirror, most of us instinctively check our speedometer even though we may have checked it a split second before. Business managers similarly feel anxious or defensive when asked about performance measurements due to the ever daunting question of IT performance and, if it is under par, the related outsourcing discussion.

To alleviate this problem, organizations should incorporate best practices by formally educating staff and benchmark participants, including them early in a performance measurement program whose goals and objectives are clearly explained.

Benchmarking, the comparing of existing values/metrics to internal or external values/metrics, is an integral part of any performance measurement initiative in virtually all businesses. While this exercise has been regularly applied to assess financial performance within companies for years, it's only over the last decade that IT organizations have used benchmarking as a management tool. In the early days, it was only utilized in data centers and mainframe shops, but by the mid-nineties, it affected all IT service areas.

Benchmarks allow organizations to understand how they compare to top performers and, in some instances, how to communicate what tangible value their IT services bring to a business. Organizations that perform internal benchmarks and compare the results to external peer groups hope to find areas where they can reduce costs, increase service levels, or improve process performance to meet growing business demands.

IT services benchmarking generally focuses on either cost or price. Both approaches are useful, but their goals and methods differ. Cost benchmarking compares internal IT services and costs of user IT organizations, while price benchmarking compares what vendors charge clients during the delivery of an outsourcing contract. This distinction can be confusing to IT managers trying to choose the most effective method for their environment.

This choice is made even more difficult when both methods are necessary to reach a monetary-based business decision (e.g., during outsourcing negotiations when making an internal cost to external price comparison using price ranges).

Unfortunately, end-user organizations have begun to view cost benchmarking as intrusive and offering limited value. They consider the effort to gather data for a benchmarking exercise onerous and time-consuming. Benchmark results are viewed with suspicion or disbelief, and are often challenged by the organization's "underperformers."

The situation is made worse when internal service structures and service levels are compared against external offerings to determine a market price or base case comparison. In this case, it's difficult to ensure that the collected base data is consistent when most clients differ in scope, complexity and service levels.

Vendors typically dislike price benchmarking exercises because clients automatically assume they will result in contract price reductions. Although this is a possibility, a reduced service price is not guaranteed if a true market comparison methodology is applied.

Despite these challenges, many CFOs are reluctant to commit to a multi-year, multi-million dollar outsourcing deal without a benchmarking clause that measures contract performance during the relationship. This is understandable. After all, would you lease a new car without a warranty?

The relationship between outsourcing clients, vendors and respective benchmarking organizations can best be described as a love/hate relationship. Benchmarking is disliked but perceived as a necessary performance measurement tool and therefore widely accepted and applied.

This article recommends an approach that can benefit end-user IT organizations and vendors interested in exploring the use of cost or price benchmarking.

Using a Cost Benchmark to Determine the Market Price for IT Services

Organizations that outsource regularly benchmark vendors' prices against similar outsourced environments to determine if their deals are still competitive, and how to remediate them if they're not.

Given the high stakes, it is not surprising that controversy exists on the best way to benchmark IT services, includ-

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ing what methodology works best, what results should look like, and who is best qualified to conduct a fair and objective benchmark study.

Benchmarking Cost

User IT organizations should use cost benchmarking to compare and contrast IT services and their delivery against peers (i.e. other IT departments providing similar services to internal business users).

Cost benchmarking should determine:

- How an IT organization's cost compares to that of best practice firms delivering IT services at similar levels; and
- How the organization's cost compares to the "average cost" incurred for similar IT services among all the firms delivering them internally. This comparative analysis must take into account costs for a given service level.

These objectives, combined with a process maturity assessment, can highlight areas where a company can improve its process and reduce costs.

Cost Benchmarking for a Base Case

IT organizations that in-source, typically use cost benchmarks to optimize performance, measure against the competition and learn from other groups that develop best practices.

In certain instances, however, a firm that outsources may find that cost benchmarks can be useful to construct a "base case," positioning the internal IT department for competition.

The base case consists of two elements:

1. The ideal cost of service; and

2. The necessary investment required to elevate an IT organization's internal IT services to a level that an outsourced vendor should deliver.

This second element is critical. Too often, user organizations simply compare vendors against their internal "budget" and the delivery cost at current service levels. A typical vendor usually opens a sales pitch discussion by saying "we can reduce your IT budget by x%."

Clearly, if business units are dissatisfied with their IT services (which may drive the decision to outsource), they should increase the prospective budget so they have the investment required to attain higher service levels. This will establish an "apples to apples" comparison between the customer cost of delivery and the vendor price.

Using a cost benchmark to construct a base case is unusual. In general, base cases should begin with the current budget, adding the necessary investment cost to elevate service levels.

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In rare circumstances a cost benchmark substitutes the budget in the base case only, for example when a "greenfield" (i.e. newly created) environment is to be implemented and no actual or historical budget numbers can be used.

Benchmarking Price

Many price benchmark studies are executed incorrectly, resulting in misleading results. Few service providers capture outsourcing contracts and proposals on an ongoing basis. Such efforts cannot truly determine a fair market price since they do not consider the full breadth of the user environment.

Research shows that many firms and consultants rely more on readily available cost benchmark information from internal IT departments, and adjust or convert this cost data into an inaccurate market price.

This is typically done through a simple—but faulty—formula, which can have negative consequences on contract negotiations:

Contract price = Cost - Leverage Factor + Profit Margin + Risk.

(*Explanation of formula: Reduce the cost by the percentage of leverage that the advisor assumes the vendor can achieve. Then add the profit margin extracted from the vendor's annual report or another source plus a risk factor.*)

To an objective and knowledgeable observer, it's evident that this formula's success in determining a realistic market price depends on several crucial factors:

1. The vendor's leverage factor against each unique environment must be correctly assumed.

2. The service provider must always bid within the assumed profit margin range.

3. A benchmarking firm needs to consider the scope of services offered by the vendor and select similar (in scope) comparators/peers of the environments the costs are derived from.

The issue with this benchmarking approach is that all the factors used to calculate the answer involve guessing to some degree since vendors do not typically share leverage factors with anyone. In addition, they may not bid according to the expectations of benchmarking firms, speculating about their profit margins.

Although a vendor's goal is to make profit, we often observe these firms offer heavily discounted contracts to achieve other business goals such as market share increases, strategic account penetration

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and short-term revenue growth.

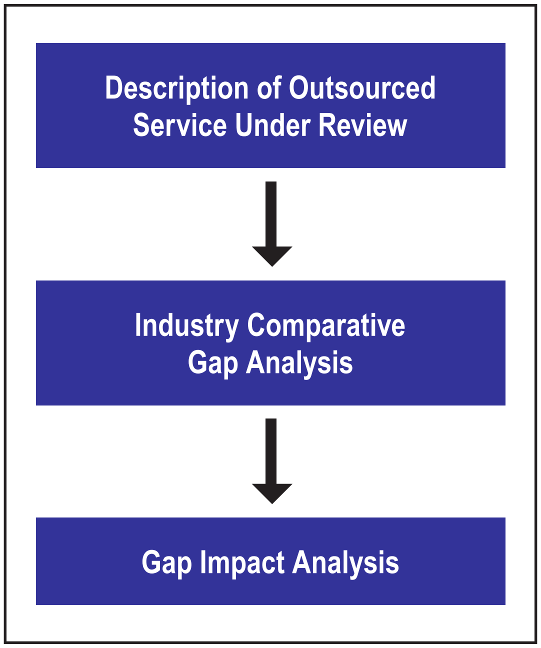
The scope of services in a typical outsourcing agreement is often fundamentally different from those provided by internal IT organizations. A challenge vendors face is demonstrating to customers the savings they can achieve versus the internal solution.

Part of the difficulty is gathering all the appropriate costs from the client organization because many of those costs, known as "shadow" costs, fall outside the purview of the IT department. An example of this is corporate overhead charges, which are not recognized in the IT budget (but should be in a good base case).

Since the information used in cost benchmarks excludes hidden costs, using cost to perform a price benchmark will omit key information and improperly assess the value that outsourcing may deliver. Cost information cannot account for the vast differences in service levels often demanded of vendors over internal services, though it may "declare" them.

Differences in these levels and costs are among the most important factors in determining outsourcing prices. Misstating their impact can distort a benchmarking analysis.

The best way to mitigate errors that may result when cost information is used to calculate price benchmarks is to base the process on price information (outsourcing contracts and pre-contract documents).



This approach enables user organizations to answer more accurately the critical questions: How much does the market charge for these services; and how does that price compare to total potential costs if these services were offered internally?

The Importance of Cost and Price Benchmarking

Depending on the unique operating model and objectives of an IT organization, cost and price benchmarking studies can be invaluable tools when applied appropriately. They help IT organizations:

- Determine the price competitiveness of IT services;
- Identify gaps in service levels;
- Prioritize IT investments and improve return on them;
- Understand processes of best practice organizations that enhance performance and customer satisfaction;
- Avoid lengthy outsourcing evaluations by quickly determining if outsourcing can yield cost savings or improve service levels;
- Save money by providing the intelligence required to negotiate outsourcing agreements effectively; and
- Maintain price and service-level effectiveness by continuing to assess the market competitiveness of sourcing agreements.

Generally, the most effective approach for benchmarking an outsourcing contract involves using comparative analysis. This requires the vendor and the client to jointly use an independent third-party advisor to work through the operational review (benchmarking) phase of the contract. This review is necessary to align price and performance during the term of a contract.

There are right and wrong ways to benchmark IT services. Both comparison "tools" (cost and price) have their clear place and benefits in managing an IT organization, but for different reasons. Although both methodologies are valuable, they are not interchangeable, so seek experienced advice if you are in doubt of what is the right tool to select.