

Market Price and Cost Comparative Analysis

*The Right Way to Determine
a Fair Price and Performance
for IT Services*





Performance Measurement Preamble:

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. To alleviate this problem, organizations should incorporate best practices by formally educating staff and benchmark participants, including them early in a performance measurement program, and explaining the goals and objectives of a performance check.

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

Benchmarks allow organizations to understand how they compare to top performing organizations 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 comes in two main varieties: cost benchmarking and price benchmarking. Both are useful, but their goals and methods differ. Cost benchmarking compares internal IT services and costs of user IT organizations, while price benchmarking compares the price that 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 and 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 service 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 that a benchmark will result in a contract price reduction. 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 white paper recommends an approach that can benefit end-user IT organizations and vendors interested in exploring the use of cost or price benchmarking.

Benchmarking and outsourcing – 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 in the market on the best way to benchmark IT services, what methodology works best, what results should look like and who is best qualified to conduct a fair and objective benchmark study.

Cost benchmarking

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 the cost of IT services from best practice firms delivering similar service levels; and
- How an IT organization's cost compares to the average cost of IT services as measured by all firms delivering similar services. The results of the 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 do not outsource typically use cost benchmarks to optimize performance, measure against the competition and learn from organizations that develop best practices. In certain instances, however, an organization 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 involves the budget to open a sales pitch discussion, 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 rare. In general, base cases should begin with the current budget, adding the necessary investment cost to elevate service levels. In rare circumstances, a cost benchmark substitutes the budget in the base case only, for example when a "greenfield" environment is to be implemented and no actual or historical budget numbers can be used.

Price benchmark

Many price benchmark studies are executed incorrectly, resulting in misleading results. Few benchmark 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.

Our 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 we think faulty—formula, which can have negative consequences to contract negotiations:

$$\begin{array}{r} \text{Cost} \\ - \text{Leverage Factor} \\ + \text{Profit Margin} \\ \hline = \text{Contract price} \end{array}$$

(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.)

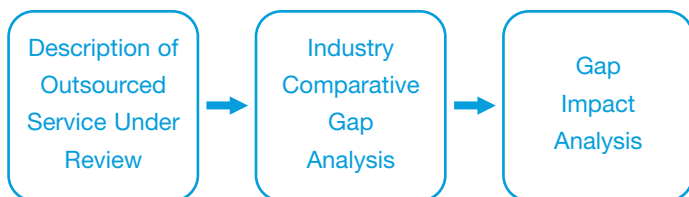
To an objective and knowledgeable observer, it's evident that this formula's success in determining a realistic market price depends on several crucial factors:

1. Leverage Factor: The vendor's leverage factor against each unique environment must be correctly assumed.
2. Profit Margin: The vendor must always bid within the assumed profit margin range.
3. Cost: The scope of services offered by the vendor must be comparable to the scope of services of the environments the costs are derived from that the benchmarking firm uses. 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, vendors 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 vendors offer heavily discounted contracts to achieve other business goals such as market share increases, strategic account penetration 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 outsourcing 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 a shadow cost that is initially overlooked in outsourcing deals 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 service 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 more accurately answer the only questions that need answering: 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. Cost and price benchmarks help IT organizations:

- Determine the price competitiveness of IT services;
- Identify gaps in service levels;
- Prioritize IT investments and improve return on investments;
- 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 effectively negotiate outsourcing agreements; and
- Maintain price and service-level effectiveness by continuing to assess the market competitiveness of sourcing agreements.

We advocate a more business-like benchmarking approach for an outsourcing contract in the form of a comparative analysis. This means the vendor and the client jointly use the support of an independent third-party advisor to work through an operational review phase of an outsourcing contract (commonly called benchmarking). This operational review is necessary to align price and performance during the term of a contract.

There are right ways 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 we recommend that you seek experienced advice if you are in doubt of what is the right tool or selection.

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