Fair Market Price

Using Benchmarks to Establish Rates for Outsourcing Services

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Introduction

By Neil Barton

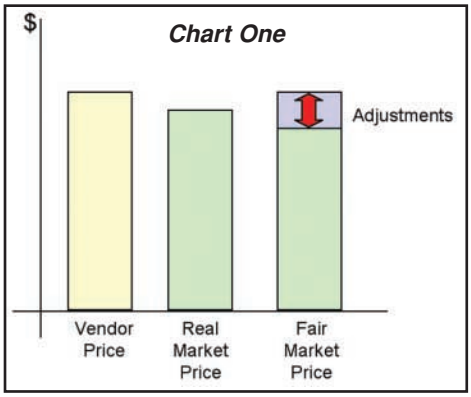
"A little learning is a dangerous thing."

— Alexander Pope (1688-1744)

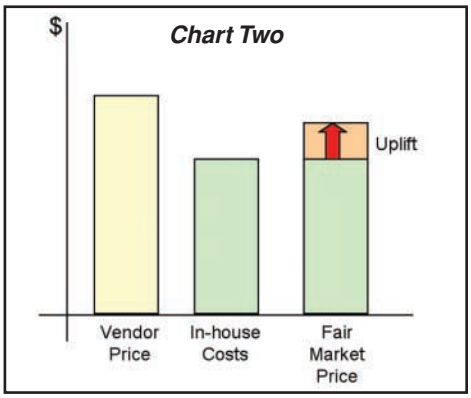
When outsourcing IT or business processes, contract life is often five years and can be as long as fifteen. This presents both buyers and vendors with a challenge. How can they ensure that the client pays a fair market price throughout, when long-term price changes are impossible to predict accurately? A benchmarking clause enables both client and vendor to carry out an external, objective appraisal of "value for money" during the life of the contract, and for prices to be adjusted based on the findings of the process.

As IT outsourcing has matured in the last ten years, two benchmarking methods have emerged – the "price-down" approach and the "cost-up" approach.

The price-down method compares the prices paid by the client against real market prices paid by other customers who buy similar services. This method works as long as price data for similar services is readily available. Where price data is available, but for different services, adjustments must be calculated to produce a fair market price, as shown in Chart One.



The cost-up method calculates a fair market price by simulating the outsourcer's costs, based on the known costs of organisations delivering similar services in-house. These costs are supplemented by an uplift to represent the outsourcer's overheads, profit, and risk. This process appears more complex than the price-down method, but is the only option when comparable market prices are not available.



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The relative merits of price-down and cost-up have been widely debated by clients, vendors, lawyers, and consultants. If the benchmark sets fair market price too high, the client could spend millions of dollars needlessly. On the other hand, if the benchmark sets fair market price too low, vendors struggle to make a profit. That's not in the interests of the client either.

This Compass white paper reviews the advantages and disadvantages of the price-down and cost-up approaches to benchmarking, and the circumstances under which the two approaches are appropriate. The author demonstrates that some contracts should be benchmarked price-down, while others should require the cost-up method.

The Price-Down Process

Price benchmarking appears to promise a simple, fast, and straightforward comparison.

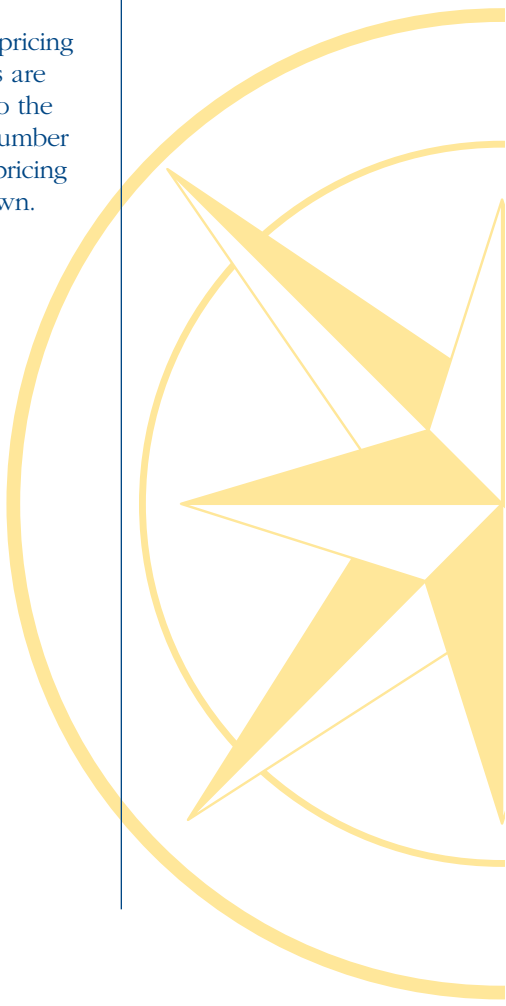
Take, for example, an outsourced IT Help Desk, where the client currently pays $15 per contact. A price benchmark compares this with a number of "per contact" price points seen at other organisations.

IT Help Desk – Price Per Contact:

Clients										
Price	A	B	C	D	E	F	G	H	I	J
$15	$9	$9.80	$10.50	$12.50	$14.50	$15.30	$16	$16.80	$16.90	$18.50

If "fair market price" was defined as the mean of the 10 price points above, the benchmark would recommend a cost per contact of $13.98, or a 6% reduction in the client's current price.

The benchmark becomes a little more complicated when outsourcers use different pricing units for different contracts. In the IT Help Desk area, for example, some contracts are priced on a flat "per user" basis, regardless of the number of contacts they make to the Help Desk. Other contracts are priced on a "per minute" basis, regardless of the number of users or the number of calls. However, a benchmark can adjust for these simple pricing variations if the other volumes (number of users, number of call minutes) are known.



Availability of Pricing Information

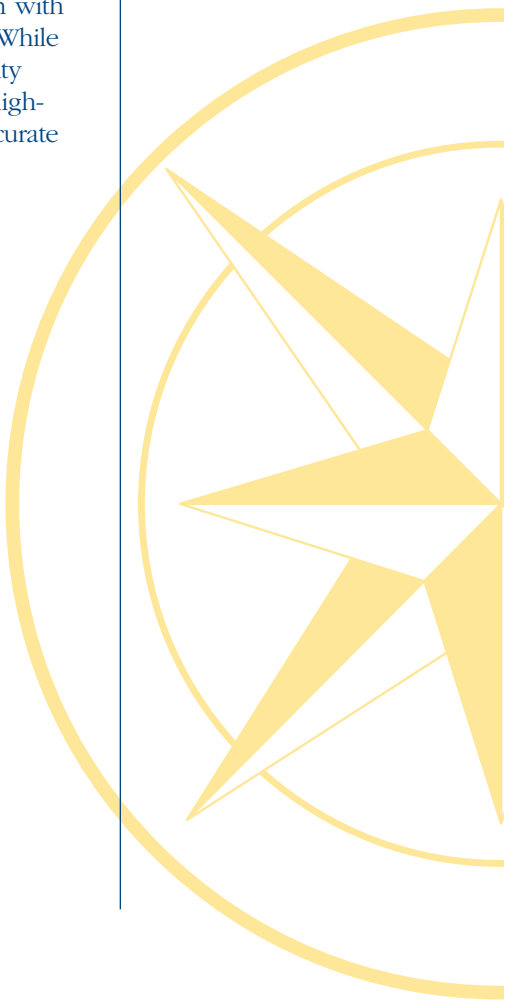
Prices in the public domain: Where can price information be found?

Press statements can include some indication of pricing. For example, in 2003 a bank announced the signing of a seven-year, $350m deal to outsource the management of 41,700 desktops. At $50m a year for 41,700 desktops, the unit price comes out at around $1200 per year per PC.

In practice, this price point is of little value. Will the number of desktops change substantially during the life of the contract? More importantly, are the desktop hardware assets included in the price, or retained by the client? Since desktop hardware typically costs $500 per year, that distinction makes quite a difference to the price comparison. It's also not clear whether the contract is simply for PC supply and break/fix services, or whether it includes additional value such as management of the file/print server infrastructure, email accounts, hardware refresh, and so on. The price may also include one-time transition costs that are not repeated. Without understanding the full scope of services delivered, carrying out a benchmark using this price point alone would be irresponsible.

Consultancies who specialise in this area benefit from much more detailed information. Because they work very closely with their clients, they know exactly what was included in the scope of a deal. The more widely a particular service is outsourced, the more price points are available. At one end of the scale, telecommunications services are almost always outsourced, since most organizations find it uneconomic to build and operate their own telecom networks. At the other extreme, some functions are almost never outsourced, such as the CIO and the "retained function" which manages an outsourcer.

Accuracy of pricing databases: Unfortunately, not all available price points can be used for benchmarking. For example, Compass was recently engaged by an organisation with two business units, each of which had fully outsourced IT to two different vendors. While one vendor had provided detailed and specific unit pricing for each task and activity delivered, the other priced over $200m a year of IT service delivery on only four high-level volumes. A benchmark based on such vague price points could be wildly inaccurate and misleading, to the disadvantage of both outsourcer and client.



Key Criteria for a Fair Comparison

Price benchmarking – while not impossible – must be done carefully, and must address a variety of issues beyond price. There are five factors which must be considered to ensure that a benchmark is accurate.

Scope

Are the services being delivered to the client comparable to the reference companies? For example, does "per server" pricing include the hardware assets, or were these retained at the client? What technology is being provided – pricing for Windows servers is very different from pricing for Unix servers. How much software is included – just the operating system, or are database management systems, middleware, system management utilities, and even applications included? Are server management tasks being carried out – does the service provider simply provide the client with a root password (as in a typical web hosting contract), or do they also take on user id administration, security management, backup and restore, tuning and capacity planning, etc.

Volume

Is the client buying in the same volume as the reference prices? For some services this can be critical. A mainframe installation of 1000 MIPS can cost three times more *per MIPS* than a mainframe installation with 10,000 MIPS. In comparing outsourced prices, the benchmark must also take into account volume breaks such as ARCs or RRCs, where the unit price varies depending on the volume bought by the client.

Service Levels

Is the vendor meeting the same service levels as those provided in the reference prices? It costs more for problems to be resolved in 4 hours than it does for problems to be resolved in 24 hours. Equally, it costs more to keep a server available 24 by 7 than only during office hours.

Location

Location influences the cost of personnel that the outsourcer hires. In all countries, labour is much more expensive in some cities than others. The person who earns US$60,000 in Texas might command US$90,000 on Wall Street. For services such as Help Desk and Application Development, where more than 80 percent of costs are personnel-based, the location of the personnel delivering the service is an extremely important price driver. This factor is most significant in the offshore outsourcing of development work.

For some services, geographical distribution may also be important. Supporting 1,000 desktops in a single headquarters building is easier than 1,000 desktops in 10 different cities.

Client restrictions

Does the client impose any restrictions on the outsourcer that do not apply to the reference prices? For example, some clients insist that each application run on a separate server, whereas consolidation would save money. Other clients rule out desktop standardisation, lock-down, or other practices that would enable the outsourcer to offer lower prices.

Adjusting Prices

A difference between the client's services and those of the reference prices can sometimes be adjusted, based on pricing options available in the reference price data. For example:

Service Description	Client	Reference Prices
Base Price	$1,200	$1,150
- assets	Included	Included
- support	Included	Included
- 4 hours break-fix	Included	$100 supplement
Adjusted Price	$1,200	$1,250

Alternatively, adjustments can be made by calculating the price of a variation "cost-up," using similar techniques to those described in the section below.

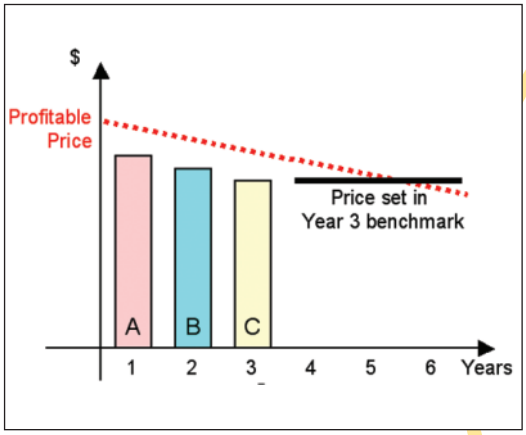
Risks of Price-Down

There remain some risks in price-down benchmarking. Most result from the commercial considerations of an outsourcer when bidding for a contract.

Single source exclusive contracts: Sometimes target prices can be set too high. Let's say, for example, that a client signs a 15-year exclusive deal to outsource a mainframe, and at a later date adds Windows servers to the contract. Because the client has no alternative source of service, the vendor is able to command a premium price. Using these price points as references in a benchmark would inflate the calculated "fair market price." This risk can be avoided either by careful selection of reference price data, or by ensuring that enough reference prices are used to dilute the effect of a few anomalies.

Back-end loading: In other cases, price benchmarking may set a misleadingly low target price. When clients negotiate hard, vendors lower their prices to retain market share. Some vendors sign up to deals that have very low margins or are even unprofitable in the early years, with the expectation that margins will increase in subsequent years to make the contract profitable overall. A client seeking short-term cost savings may even request this so-called "back-end loading."

The diagram shows a sample service where the unit prices have been falling 5 percent a year. In year 1, outsourcer A wins a contract by bidding a price under their target profit level, with the expectation of recouping this investment in year 3 and onwards. Next year, outsourcer B does the same, and so does outsourcer C the following year. In this third year, outsourcer A's contract is price benchmarked using the recent market pricing set up by the other two. As a result, A's price is reduced by 10 percent.



This contract will not now enter profitability until year 6, and even this is at risk if the client chooses to benchmark again in year 5. The outsourcer will have no flexibility to act as a partner in such a loss-making contract. Nor will the outsourcer have an incentive to provide additional services to the client, since a fair profit cannot be made from the account. The client, in turn, will fail to exploit new technology for business advantage and will likely watch its technology become obsolete and out-of-date.

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Worse still, when the time comes to renew the contract, the incumbent vendor will understandably show little interest in maintaining the relationship. New vendors may not bid at the same low prices as the existing contract, leaving the client to explain internally why IT services are rising in cost for no discernable improvement.

Other effects of back-end loading: An opposite inaccuracy may occur if prices are only taken from contracts at the end of their contract life. Outsourcer margins are commonly much higher at this point, when transition costs are out of the way and the operation is running smoothly. Use of reference prices from these contracts could easily cause the target price to be set too high.

Cross subsidisation: A further complication arises when one service subsidises another. For example, while an outsourcer's overall margin on a contract might be reasonable but not excessive, the desktop service could be charged at a very low margin, with the mainframe service at a much higher level. (This can happen as a result of a conscious pricing decision by the outsourcer during bidding, or by accident when a client's actual volume requirements vary from what was expected when the contract was signed.) If a price benchmark were carried out on just one of these services, target pricing could be set either too high or too low, depending on which service was selected.

Handling risk in price benchmarking: The risks of price benchmarking, summarised in the table below, can all be avoided. However, they illustrate that for long-term complex contracts, prices often do not provide a simple like-for-like comparison process.

Risk	Effect	Acton Needed To Avoid
Single-source "exclusive" contracts	Target price set too high	Careful reference price selection Increase population of reference prices
Back end loading (using pricing from recent contracts)	Target price set too low	Careful reference price selection
Back end loading (using pricing from end-of-life contracts)	Target price set too high	Careful reference price selection
Cross-subsidisation	Target price may be either too high or too low	Always benchmark the whole contract, not one service out of context

The Cost-Up Process

In some instances, the risks of price-down benchmarking outweigh the benefits, and the seeming simplicity of the price-down model becomes overwhelmed by the additional calculations required. In such cases, an alternative approach is warranted. With the cost-up method, Fair Market Price is calculated by recreating the financial model of the outsourcer based on known information about the cost of delivering the services in question.

In the Compass methodology, the price paid by a client is analysed against the average cost of top-performing in-house organisations delivering similar services. The table below provides a simplified illustration.

Service Description	Vendor's Price	Target Price
300 MIPS Mainframe load	$5100/MIPS	$1.47m
7 Tbyte storage farm	$400/Gbyte	$2.59m
60 NT servers	$12,000/server	$0.66m
Uplift (see below)	–	$0.98m
Total Annual Price	$5.05m	$5.66m

Cost-up calculations have been the benchmarking method of choice for most of the last ten years. When the outsourcing industry was immature and pricing schemes varied widely, it was the only practical method. Today, it remains in use when price benchmarking is judged to be too inaccurate for a particular deal.

Availability of Cost Information

Applying the "cost-up" method requires extensive knowledge of performance information within both in-house and outsourced organisations. Detail is essential, because high-level budget and headcount information can miss as much as 40 percent of the true costs of delivering IT. More importantly, understanding the detailed activities involved in delivering each service is needed to accurately re-create the outsourcer's cost model.

For example, knowing that 10,000 desktops are being managed is not sufficient. The calculation must also consider how often each PC is moved (sometimes once a quarter, sometimes once a year), and how much file server storage is provided to each user. The Compass models break down IT into 100 separate sub-processes, and identify 150 separate tasks an outsourcer might carry out. This granular level of detail provides very high accuracy in re-calculating the outsourcer's cost model. One top-tier outsourcer revealed that the Compass independent calculation of required personnel was almost exactly the same as their own.

For services that are almost always outsourced, however, a cost-up calculation isn't appropriate, since the necessary internal cost reference data simply isn't available. Telecom transports and PC maintenance (so-called "break/fix") are examples of services no longer carried out in-house. As the outsourcing market matures, more services will likely evolve this way. Signs of commoditisation are already emerging in services such as IT Help Desks, desktop management, LAN, voice, and even server management. The growth of offshore outsourcing is having a similar impact on certain aspects of software development.

Key Criteria For A Fair Comparison

All five factors influencing price comparisons are also important for cost-up calculations:

Scope

Costs must be added or removed from the reference costs to match the services and technology provided by the outsourcer.

Volumes

The target price should factor for economies of scale, and any difference in size between the client's 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 organisations.

Other Factors – Efficiency

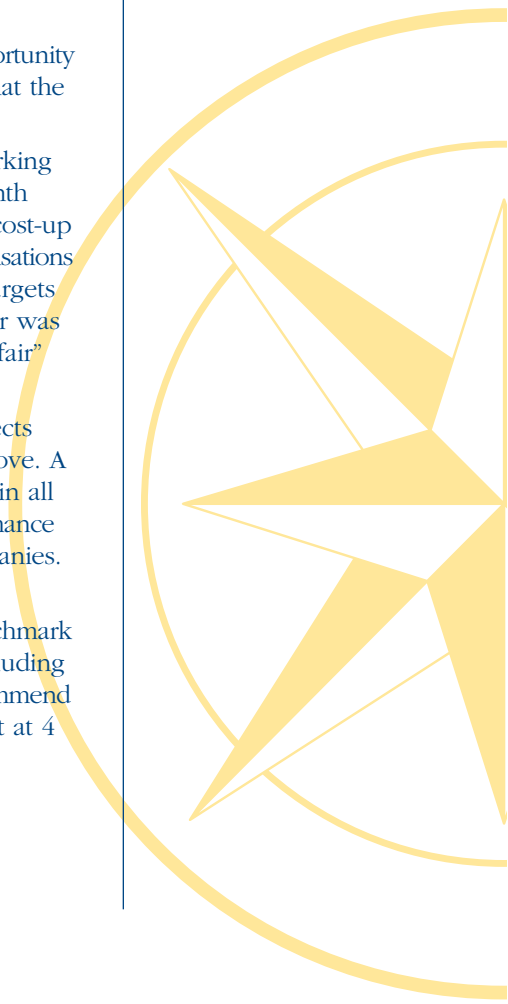
In addition to these basic factors, a number of additional considerations must be made when conducting a benchmarking exercise based on cost-up calculations.

Outsourcing to save money: Organizations outsource for many reasons, but the opportunity to save money is nearly always one of them. Many clients want to be reassured that the prices they pay are competitive, not average.

Use of "quartiles" in benchmarking clauses: One common way to define benchmarking criteria is to state that reference data must be drawn from the "top quartile" or "tenth percentile." This approach, however, presents considerable disadvantages for the cost-up method, as it does not distinguish between cost and service quality. In practice, organisations with the lowest costs may offer unacceptably low service levels. Setting price targets based only on these lowest-cost organisations would therefore mean an outsourcer was expected to provide top service levels at bargain basement prices – clearly not a "fair" outcome.

Comparing performance against "best performers:" An alternative approach selects reference costs from a pool of companies meeting the five "Key Criteria" listed above. A selection is made of around six companies that have achieved good performance in all respects – cost, productivity, quality, service levels, and satisfaction. Target performance levels are then set based on the average (mean) of these six "best performing" companies. This broad and balanced range of performance criteria ensures a fair comparison.

More value in the benchmark: Applying a range of performance criteria to the benchmark also broadens the actions that may be taken. For example, instead of simply concluding that "this price should be reduced by 5 percent," the benchmark process might recommend as an alternative: "for this level of pricing, problem resolution targets should be set at 4 hours instead of 8 hours."



Other Factors - Uplift

The "cost-up" method must take into account three remaining factors:

- Overheads
- Profit margins
- Risk fees

These three factors comprise the "Uplift" to the reference costs (Overhead + Profit + Risk = Uplift). Uplift and Reference Costs, in turn, make up Fair Market Price (Reference Costs + Uplift = Fair Market Price).

Overhead

An outsourcer's overhead, or "Sales & General Administration," consists of business expenses incurred by an outsourcer that are not usually found in an in-house organisation. Examples might be the sales & marketing effort required to win new contracts, the financial, legal, and business management of the outsourcer's business, and so on. These overheads must be assessed carefully, as in-house organisations also have service management and relationship management personnel who may have been included in the reference costs. When carrying out a benchmark, outsourcer claims for these overheads should be reviewed, and accepted or declined depending on how closely each one matches the reference costs in the database.

Profit

Profit represents the margin an outsourcer expects to make from a given client account. A fair market price must factor for this, as an unprofitable account is in neither party's interest. An unprofitable account provides the outsourcer less room for manoeuvre in the partnership, and less incentive to be accommodating. For example, an unprofitable vendor may insist that the original contract is interpreted very strictly in all discussions, creating an adversarial culture which damages the long-term relationship. In bad cases, the outsourcer concludes that the client offers no future business opportunities, and re-assigns the most creative and capable people to other accounts. In the worst cases, the outsourcer goes out of business, jeopardising the stability of the client's operations. For all these reasons, target pricing must include a certain level of profit.

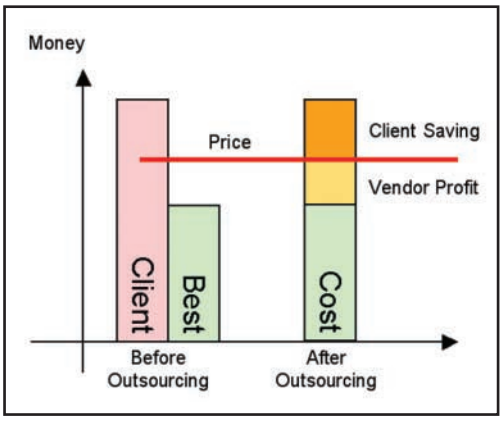
Risk

The fees that outsourcers may charge for risk comprise a final component of uplift. As with overheads, specific claims on each deal should be reviewed. Some claims are justified. Outsourcers genuinely manage risk if the inventory of assets turns out to be inaccurate, or if a client has the ability to substantially reduce expected spend at short notice. On the other hand, some claims are not justified. Some outsourcers have claimed that risk fees should apply to potential performance penalties. In Compass' view, penalties should be drawn from the outsourcer's profit margin if they are to be effective incentives.

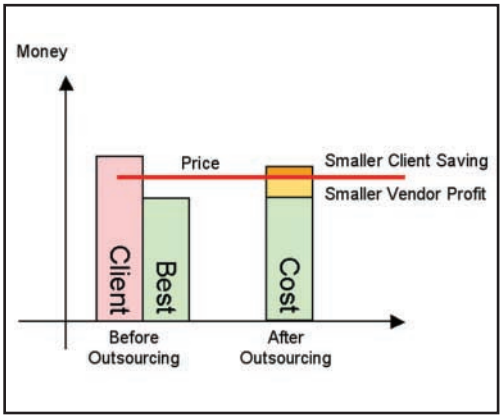
Baselining and uplift

Should an uplift be calculated at all? It depends partly on when the benchmark is being done.

In an ideal scenario, the outsourcer can both make a profit and save the client money. This happens when a client's in-house IT is much more expensive than "best in class." By outsourcing, the client benefits from the outsourcer's economies of scale and superior management practices. Both are happy throughout the relationship



On the other hand, when a client decides to outsource a function which already operates near "best in class," the relationship can be much more difficult. Even if the outsourcer continues to run at the same efficiency levels, they must accept a much smaller margin if the client has expectations of major cost savings. A win-win relationship is much harder to achieve – there is less "win" to share around.



The best way to avoid this scenario is to baseline in-house costs comprehensively before the outsourcing deal is signed, taking into account the nature and length of the contract. Taking the time to do this is a form of due diligence which will help both client and outsourcer to manage their partnership in the long term.

When Compass is engaged to help select an outsourcer, in-house costs are analysed against proposed prices. In these engagements, Compass does not add uplift to existing in-house costs. If the client expects to save money through outsourcing, the combination of outsourcer's cost and uplift must be less than the current cost base, unless there are value-added benefits that the outsourcer delivers over the life of the contract. However, when carrying out a mid-life contract benchmark using the "cost-up" method, Compass does calculate an uplift. This recognises firstly that the contract must be viable for the outsourcer long term, and secondly that the option of switching to another vendor or re-insourcing these services is likely to be too expensive and too time-consuming for the client to consider.

The Uplift Challenge

Outsourcers' reluctance to share commercially sensitive figures such as overhead, profit, and risk presents a challenge for benchmarkers in calculating uplift. In addition, uplift varies considerably by the service being benchmarked – commodity services force vendors to accept lower overheads and lower margins than do high-value services. Uplift also varies over the life of a contract – for example, if a client and vendor agree to "back-end load" a contract, a cost-up benchmark carried out later in the contract life would reasonably include a higher level of uplift.

Uplift can be calculated by several methods.

- Estimation – uplift is estimated based on a combination of consultant experience and the financial results published by outsourcers
- Agreement – client, outsourcer, and benchmarker agree on a value to use for the purpose of the benchmark
- Observation – the benchmarker sets uplift based on the difference in costs and prices seen in their database

Each approach has its strengths and weaknesses, and sometimes a combination may be needed.

Conclusions

Selecting Price-down or Cost-up

Both methods are needed: In some instances Fair Market Price should be calculated price-down, and in others it should be calculated cost-up.

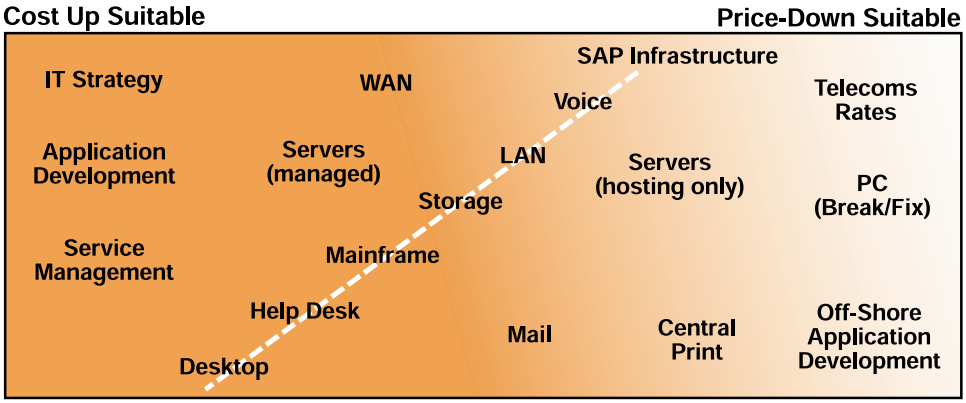
Selecting the appropriate method must consider a number of factors, summarised in the table below:

Price-Down Suitable When …	Cost-Up Suitable When …
Vendor's pricing is detailed	Vendor pricing is too high level
Services are commodities and vendors price the service in similar ways	Large multi-service contracts in which some services may have cross-subsidised others
Comparable price points are available	Insufficient comparable price points are available
	Contracts include a high proportion of intangible "value add"

The Significance of "Commoditisation"

A key part of the decision depends on the level of commoditisation of the benchmarked services. A commodity for this purpose is defined as a service which all vendors offer in the same form, competing primarily on price. The diagram below shows the state of IT service commoditisation in mid 2003, with commodity services shown at bottom right, and non-commodity services shown at top left. This picture changes rapidly, however, with the number of commoditised services increasing each year.

In practice, therefore, each deal must be considered individually. The benchmarker may need to review the pricing scheme and the details of the services delivered to determine the best method. Consultancies that can deliver either the price-down or the cost-up method therefore provide much more accuracy to their clients than those that can offer only one.



Investing In Careful Benchmarking

Overly simple comparisons are not only inaccurate, but will actively damage the long-term partnership on which an outsourcing contract must be based. As Alexander Pope wrote 300 years ago, "a little learning is a dangerous thing."

Nine Key Factors

The table below summarises the nine factors that must be taken into account to ensure an accurate analysis. Price-down benchmarks only need consider five of these factors, and can provide an accurate comparison as long as comparable price data is available in the market. Cost-up benchmarks are less constrained by market pricing practices, but must take into account four additional factors.

	Factor	Price-Down	Cost-Up
1	Scope	Yes	Yes
2	Volumes	Yes	Yes
3	Service Levels	Yes	Yes
4	Location	Yes	Yes
5	Client Restrictions	Yes	Yes
6	Efficiency	–	Yes
7	Overheads	–	Yes
8	Profits	–	Yes
9	Risk	–	Yes

In summary, a Fair Market Price benchmark evaluates both cost and price data, and adjusts for all necessary external market pressures and internal delivery efficiencies. It demonstrates if an outsourcer is charging within a reasonable band for the mixture of services specified in the contract, and it recommends not just price changes but also service, quality, and process changes. That way lies a long and mutually rewarding relationship between outsourcer and client.

The benchmark is only one of a number of management tools necessary for the long-term governance of an outsourced contract. It provides a basis for negotiation on long-term price maintenance, but it should be complemented by the correct processes, procedures, and relationships for both sides of the partnership to win.

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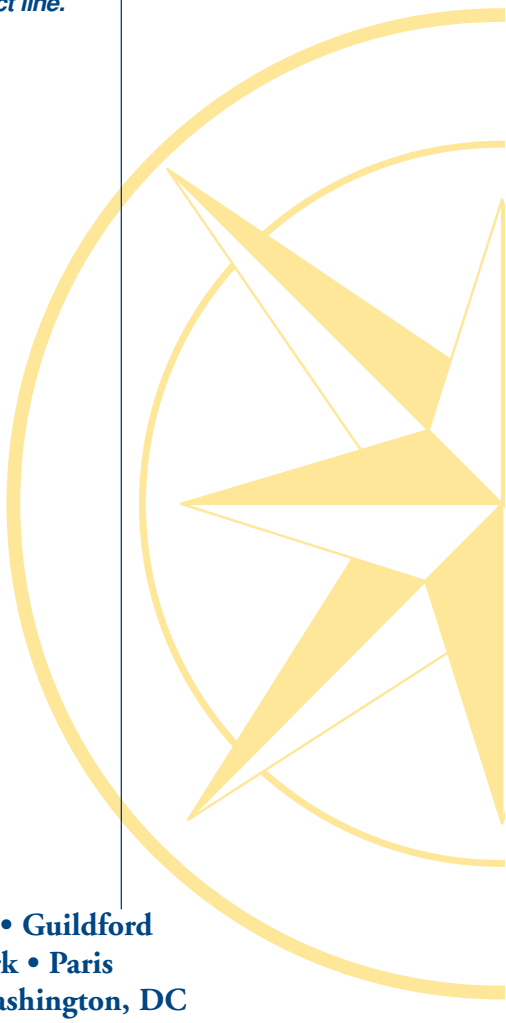

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