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Contract Benchmarks and a New Level of Operational Excellence

Nigel Hughes, Partner, ISG

ISG WHITE PAPER

INTRODUCTION

Benchmarking is an established tool for managing outsourcing relationships, traditionally applied to validate and/or improve the value of a contract.

Increasingly, benchmarking analyses are becoming integral to the overall sourcing and operational strategies of top-performing organizations.

Effective benchmarks continue to identify opportunities in even the tighest-run ships.

Cost reduction remains a priority, and while many organizations have achieved world-class levels, effective benchmarks continue to identify opportunities even in the tightest-run ships. Benchmark analyses are also proving to be critical to managing broader transformational changes in the way IT services are procured and delivered; specifically, through programs based on demand management and implementation of standard service delivery models.

This white paper discusses how benchmarking analyses of outsourcing contracts can help client organizations and service providers improve performance and develop more effective relationships. Specific points discussed include:

1. How benchmarking fits into a portfolio of contract management tools
2. Factors that cause benchmarks to fall short of expectations
3. Key characteristics of effective benchmarks
4. Emerging opportunities to use benchmarks in transformational initiatives

ROLE OF BENCHMARKING

Benchmarking is the analysis of one organization's performance against the comparable activities of other organizations, or its own performance over time. By highlighting the differences between a given organization's performance and a comparative reference standard, the benchmark should identify improvement opportunities and point the way towards activities required to achieve superior performance.

When used to analyze outsourced delivery, a benchmark should:

1. Establish if services are being delivered at a competitive market price for the contracted service levels
2. Quantify improvement opportunities within the context of the existing delivery model
3. Quantify improvement opportunities resulting from a change in the delivery model, whereby non-essential requirements and constraints imposed by either party are removed
4. Adhere to the key principles of transparency, independence, and inclusion of all parties throughout the benchmarking process

KEYS TO SUCCESS

An effective benchmark analysis should be part of an ongoing and proactive organizational commitment to quality and continual improvement – including but not limited to cost reduction.

The key to driving improvement lies in understanding how and why performance deviates from the target.

The goal of a benchmark exercise should therefore be to highlight *differences* between an organization's performance and that of the reference standard, because the key to driving improvement lies in understanding how and why performance deviates from the target.

These differences are not simply side-by-side pricing comparisons showing a net gap or surplus. Rather, a benchmark should yield insight into the historical context and unique characteristics of the client organization and how they contribute to performance. The benchmark should also define the different types of operational constraints and client choices within the organization, and what levers can address those constraints and thereby improve performance.

From this perspective, a benchmark analysis becomes much more than a periodic "health check" or high-level barometer of cost and quality. Rather, it becomes a core part of the operational strategy, an engine that drives incremental improvement as well as transformative change.

One key element of an effective benchmark is a **Long-Term** View. Consider this example: a benchmark finds that a client is paying significantly more than market rates for storage technology. However, the high costs are driven by the client's existing environment and unique business requirements, which increase demand for storage resources. Obsolete data processes and myriad legacy systems, meanwhile, lag behind the business' information management needs.

A short-term, tactical approach would be to use the benchmark findings to institute immediate market-based price adjustments. While that may provide short-term relief, both parties would ultimately suffer, as the vendor would be unable to viably support the client, and the client would be exposed to the risks of an inadequate and insecure data storage environment.

In this instance, the benchmark is properly used as a baseline from which to chart a roadmap toward a future state aligned with the client's needs. Subsequently, the client and vendor work together to implement a transition initiative to replace legacy systems with more streamlined storage platforms, and to develop a program to more effectively manage information by categorizing and prioritizing access to data throughout the enterprise.

More specific characteristics of an effective benchmark include the following:

Effective benchmark agreements focus on transparency not only into the results, but into the benchmarking methodology, data, and analytical process.

Transparency and Collaboration are essential to ensure that all parties accept the benchmark results and are willing to use those results as the basis of substantive post-benchmark discussions. Joint Terms of Reference in the agreement govern the details of the benchmark and address potential errors, omissions, or misunderstandings. Doubts or obfuscation surrounding a benchmark invariably complicate negotiations. Increasingly, effective benchmark agreements focus on transparency not only into the results, but into the benchmarking methodology, data, and analytical process. Relatedly, a collaborative approach facilitates open discussion rather than contentious confrontation between client, service provider, and third-party advisor.

Appropriate **Comparators and Adjustments** are also critical to ensuring that all parties accept the results as the basis of negotiation. The comparison should be based on agreed-upon criteria, such as, for example, the simple mean of six of the best data points available. In older contracts with quartile or other percentile targets, statistically reasonable peer group sizes should be used. Criteria for data normalization – another potential point of contention – should openly address issues raised by either party.

Potential **Challenges and Disputes** should be addressed through clearly defined terms included in the standard contractual process, including terms for an audit of the benchmark.

Timing of benchmarks is critical. Generally speaking, a baseline analysis should be conducted prior to transition, and then subsequent analyses should be conducted every other year. Benchmarks conducted too late in the contract term risk becoming an instrument of last resort to arbitrate conflicts, rather than a means of facilitating dialogue.

A lack of ambition is one general characteristic of ineffective benchmarks.

BENCHMARKS MISUSED

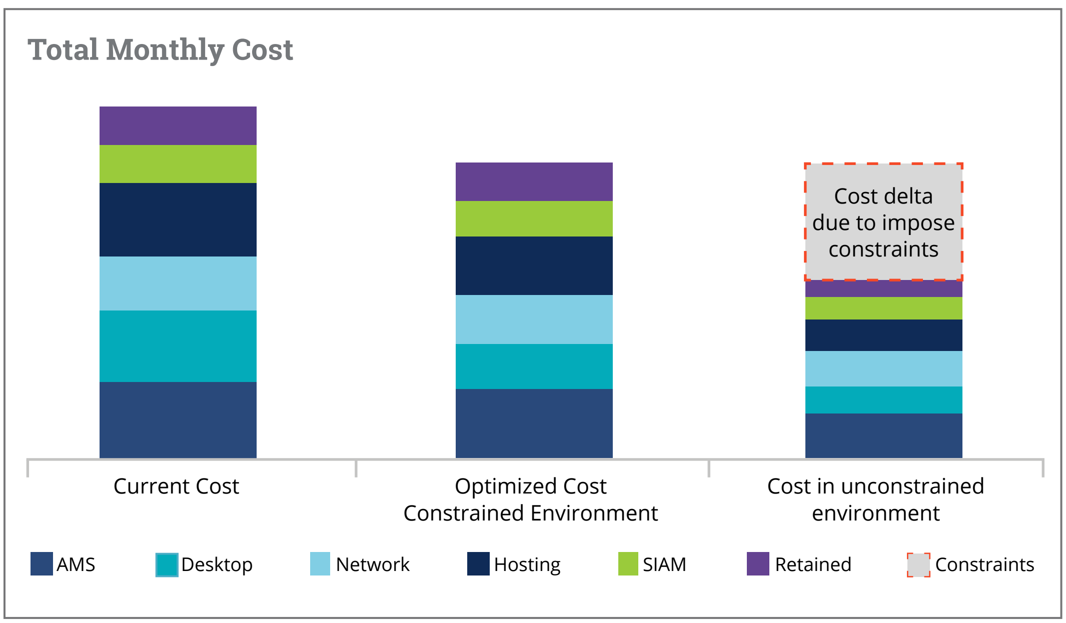
Despite their potential benefits, benchmark analyses often fail in practice to deliver their full potential, or are downright counter-productive.

A lack of ambition is one general characteristic of ineffective benchmarks. Initiatives limited solely to "validation" or to taking a "pulse check" of existing services typically reinforce complacency and inaction, producing vague results and little guidance towards driving improvement. The appeal of a quick-and-easy or "automated" benchmarking exercise conducted at minimal cost ultimately proves illusory, as organizations discover that they've paid for an analysis that offers no value whatsoever.

Another common pitfall occurs when benchmarks are invoked as a last resort in a failing relationship. In such circumstances, when all other means of communication have been ineffective, benchmarks used as a stick to beat the vendor into lowering prices do not deliver the best results.

IMPROVEMENT DOUBLED

Compass Benchmark data shows that traditional improvement initiatives drive incremental efficiency gains within the existing operational environment, and typically produce annual savings of 10 percent to 20 percent. A transformational approach to improvement, characterized by an optimized IT delivery model, utility computing, and a collaborative approach to identifying and implementing improvement, often produces overall cost savings of 40 percent or more. (See graphic below.)



In other words, rather than tightening the screws on the way things have always been done, IT leaders are establishing a new and significantly better way of doing things – a clean slate that fully leverages the benefits of standardization and utility computing.

The improvement reflects both increased delivery efficiency from the supply side, as well as improved commercial management from the demand side.

Benchmarking plays a central role in a transformational strategy, by quantifying the current state and the “size of the prize” of an optimized environment. With the target identified, the roadmap to the standard delivery model can be charted. The characteristics and complexity of the existing environment help define the type of business team that will be needed to manage the change initiative.

Top-performing organizations increasingly find that effective benchmark analyses are integral to maintaining optimal operational efficiency and to continually identifying new improvement opportunities.

In addition, benchmarks are proving essential to change strategies in terms of identifying the potential benefits of transformational initiatives and charting a path to achieving significant performance gains.

ABOUT THE AUTHOR

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NIGEL HUGHES
Partner

Nigel leverages more than 20 years of experience in service development, change management and sourcing strategy to help his clients save money and discover the long-term benefits of operating IT commercially. Nigel works with companies around the world and across a variety of industry sectors helping enterprises move to agile delivery models based on the delivery of standard services and the exploitation of emerging technology in both IT and business operations. Nigel's expertise includes the use of benchmarking techniques and scenario analysis as the basis to drive informed change. He has an MBA and a BS in Mathematics, which he utilizes to analyze companies for opportunities to save money and time. He is recognized as a thought leader on service catalog construction and TBM.

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