Formal Benchmarking in Outsourcing Contracts: TPI’s Position

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 CONTENTS

2. Introduction
3. Benchmarking as a Contract Tool
4. When to Use Benchmarking
6. Benchmarking Process and Elements
11. Elements of a Benchmark Clause
13. Summary and Conclusions: TPI’s Position on Benchmarking
INTRODUCTION

TPI clients have consistently stated that they must be able to measure the difference between contract pricing and prevailing market pricing. This requirement is especially crucial in longer-term contracts. As both clients and service providers have concluded, however, relying on a formal benchmarking clause to meet pricing variances is not always proving to be effective in today’s outsourcing industry.

This paper discusses how to use formal contract benchmarking to help address variances; it explains how parties can use benchmarking as a more effective tool in sourcing relationships; and it helps parties to better understand the following:

1. **Benchmarking as a contract tool**: how benchmarking fits into a portfolio of contract mechanisms for maintaining contract price competitiveness
2. **When to use benchmarking**: those situations in which a benchmark clause might apply and those in which it does not
3. **Benchmarking process and elements**: once parties can grasp the purposes and limitations of these benchmarking essentials, they can become empowered to negotiate both realistic and effective clauses for their specific contract situations

*AHEAD* … viewing formal benchmarking in perspective among a range of tools for maintaining contract competitiveness …
BENCHMARKING AS A CONTRACT TOOL

Contracting parties should understand that benchmarking is simply one tool among several that make up a portfolio of contract mechanisms for maintaining contract price competitiveness.

- These mechanisms include:
  - Shorter contract lengths
  - Reasonable termination for convenience rights and fees
  - Insourcing or re-sourcing flexibility
  - No minimum commitments
  - Informal client-driven benchmarking/market assessments
  - Invocation of a formal contract benchmarking clause

Price competitiveness can be maintained by balancing the use of all available tools. Clients should come to understand the role that each mechanism plays in leveraging price competitiveness, along with the limitations of each mechanism, to avoid becoming overly focused and reliant on only one tool as outsourcing contracts are negotiated. By fully understanding and considering all available tools, they can maximize their capability to ensure price competitiveness throughout the term of the contract.

As part of this balanced and realistic positioning of tools, clients must view formal benchmarking in perspective—developing practical expectations of what formal benchmarking can and cannot do, appreciating that it is not always a smooth process and understanding that it is not a guaranteed solution for maintaining price competitiveness. Benchmarking provides a mechanism to fairly address major shifts in market pricing over long-term agreements. Some evidence indicates, however, that this formal benchmarking objective has changed for some clients over the years.

To properly assess its role as one tool among several, we should consider the original commercial rationale for benchmarking and realize why in some cases clients have moved beyond the rationale and capabilities of the benchmarking process.

NEXT ... dangers of mis-using or over-managing the benchmarking process ...
WHEN TO USE BENCHMARKING

The Purpose of Formal Benchmarking

A benchmarking clause is used in an outsourcing contract as a check against significant price “drift” over time. Such drift is of particular concern in longer-term contracts, where major discrepancies can occur between contract prices and market pricing. Most outsourcing contracts, especially longer-term ones, have complex mechanisms in place for changing contract prices. These mechanisms are the primary drivers of micro-price adjustment and include:

- Year-on-year productivity improvements
- Inflation adjustments
- Adjustments for changes in required service volumes

The underlying commercial basis for including a benchmarking clause is not to treat it as a supplement to these mechanisms, which would cause it to become just another tool to enable an additional micro-price adjustment.

In recent years a subset of clients appear to have revised their expectations and to have set out to use the benchmarking clause opportunistically, as a sensitive lever that can help calibrate regular small price adjustments. They have moved past the original commercial rationale and the capabilities of the benchmarking process maybe to their own short-term financial advantage, but usually at a considerable cost to their sourcing relationship. There is corresponding evidence that this practice has led to a more focused and systematic management of the benchmarking process by service providers.

Benchmarking clauses are a necessary and useful tool when they are used in the correct context. But a combination of misused benchmarks and over-management of the benchmarking process has contributed to a serious industry decline in the perceived value of contract benchmarking, and, therefore, a decline in its effectiveness.

Contracting parties can rehabilitate benchmarking effectiveness by expecting realistic levels of detail and accuracy from the process. One way to eliminate misuse and over-management is to understand those contract situations to which a benchmarking clause applies.

NEXT … In what types of contract situations are benchmarking clauses more appropriate? Less appropriate?
Context for a Benchmarking Clause

As previously stated, benchmarking is just one of several tools that parties can use in contracts to help ensure price competitiveness over time. A single approach for using benchmarking cannot be prescribed; rather, one must consider the specific situation and decide if one can apply benchmarking. The following broad guidelines can prove useful.

A benchmarking clause is more appropriate for:

- Longer-term contracts (greater than five years)
- Well-defined, commonly outsourced services
- Services where data is available or may be reasonably expected to become available

A benchmarking clause is less appropriate for:

- Shorter-term contracts (less than four years)
- Services not commonly outsourced
- Services where data is not available and cannot reasonably be expected to become available
- Services with large components of transformation embedded through the contract life

These guidelines indicate situations where parties may misuse the outcomes of benchmark clauses because they misunderstand the way in which the clauses are constructed. One outcome of this confusion is the attempts of clients and service providers to apply benchmarking to small price adjustments. To grasp why this attempt is made, we must examine the role of benchmark data in benchmarking clauses.

AHEAD … a sample benchmark clause structure.
BENCHMARKING PROCESS AND ELEMENTS

Understanding Benchmark Data

Parties trying to understand benchmark data must consider a number of variable factors, including 1) the complexity of pricing data; 2) the role of data normalization; and 3) the choice of the proper pricing measure.

Market pricing data is not as stable as one might think because outsourcing services are not priced as commodities, nor are service prices typically available in the public domain. One can plausibly conclude, therefore, that service providers are unable to sustain consistent pricing. Additionally, market pricing is not linear. Some find this feature of service pricing surprising, but it is a very important factor that parties must consider when deciding how precisely they can gauge the accuracy of data and benchmarking. Inconsistent pricing can understandably result from a combination of inherently volatile pricing factors, the uncertainty of competitive bidding, significant differences among required services and the dynamics of the market. Price point ranges of up to 50 percent or more for similar services are not uncommon.

What is Data Normalization?

Most benchmarkers follow a data normalization process so they can better apply their data to the specific circumstances of the price/cost point that they are working to compare. The normalization process is applied because no two situations are exactly the same. Normalization adjustments take into account the different characteristics (such as service scale, scope, complexity, etc.) of the data points in two different situations.

A benchmarker who must use data points from one situation to get a benchmark for a different situation often will adjust the original base data point. The normalization adjustment, therefore, is a benchmarker judgment applied to a base data point. The quality of the comparison data points and how close their values are drive the degree of judgment applied in a benchmark.
Normalization can lead to a large degree of contention. A benchmark where data points undergo relatively small amounts of normalization is likely to be seen as more “fair” than one in which many of the data points undergo considerable normalization. Some benchmarkers routinely share the amount of normalization they used in their analysis, but others do not. Sharing of the “pre-normalized” data points can get very close to revealing the original data and may thus create legitimate concerns about confidentiality.

Choosing the Right Pricing Measure

Several years ago, a trend in outsourcing contracts developed whereby a benchmarking clause was expected to include a pricing analysis measured in data quartiles. Many statisticians state that they need 60 or more data points to produce accurate quartile readouts, and they generally agree that a quartile positioning with fewer than 20 data points has limited value. But because it is difficult to find truly comparable peer data (same scope, scale, geography, etc.), statisticians have concluded that finding 20 or more such relevant peer points is unrealistic. Worse yet is that a contract requiring this much data can easily become grounds for dispute if the benchmarker cannot provide the required detail.
Despite these complications, many existing contract clauses still require quartile measurement. However, the best practice today, and the recommended approach from major benchmarkers, is to base measurement on the simple mean of six or more of the best data points available.

TPI’s Position on Using Benchmark Data

To write and implement better benchmark clauses, the negotiating parties must understand the make-up and previously described limitations of benchmark data. TPI believes that neither the outsourcing marketplace nor benchmarking data can support claims for micro-accuracy (within 10 percent of the threshold as depicted in the following diagram). Market pricing is not consistent, and available data has limited precision, especially after normalization. Experience has shown that disputes and prevarication often result when benchmarking is used to reach micro-degrees of accuracy and when parties challenge the basis of data and the degree of normalization.
Benchmarking clearly has its place, though, and available data certainly contains meaning. TPI believes that benchmarking can be used to indicate macro-discrepancies exceeding a reasonable threshold – between 10 and 15 percent – in target pricing to market. Further, TPI strongly recommends that the contract state a threshold that is subject to the service and to the situation.

Sample Benchmark Clause Structure

Incorporating our knowledge of data limitations as described above, TPI has set out the features of a benchmarking clause that uses data whose make-up and limitations are understood. TPI recommends these features because they offer a balanced group of initial considerations that clients may adapt to each unique contract situation.

**Frequency of Benchmark**

The frequency of the benchmark can be determined at the client’s discretion, from time to time during the term. For example:

- 3-year term – no benchmark
- 3- to 5-year term – maximum of once after month 18
- More than 5-year term – after month 18, but not more frequently than every 24 months
**Scope of Benchmark**

The scope of the benchmark can be one or more entire functions/towers, which can vary by country, at the client’s discretion.

**Factors to Consider**

The benchmarker must take into account the following factors:

- Transition/transformation
- Unique client requirements
- Taxes
- Asset purchase, initial or future
- Unique staff provisions
- Differences in volumes, scope, service level agreements, etc.
- Other factors that benchmarker deems relevant

**Engaging the Benchmarker**

The following are terms of engagement for the client and benchmarker:

- Client pays the benchmarker’s fees
- Client consults with the service provider, but client ultimately chooses the benchmarker
- Parties optionally agree to an approved list of benchmarkers

**Benchmarker Qualifications and Requirements**

The following describes benchmarker qualifications and how a benchmarker interacts with service providers and clients:

- A client shall engage a benchmarker who is an industry-recognized benchmarking service provider. Qualities should include:
  - Independent
  - Demonstrated experience in performing benchmarks
  - Permitted to anonymously reuse all benchmarking data on other benchmarking studies it performs
- Service provider shall cooperate fully with client and the benchmarker and shall provide reasonable access

**Benchmark Process**

The following describes how the benchmark process is implemented:

- Some elements of the benchmark process may be prescribed, but the process can be amended upon reasonable benchmarker recommendation
The benchmarker shall provide to the parties jointly a reasonable explanation of its methodology, including its use of relevant comparative data and to what extent the benchmarker’s judgment was applied versus objective data.

The benchmarker will independently administer benchmarking in a manner consistent with such methodology and will conduct benchmarking so as not to unreasonably disrupt service provider operations.

**Obligations and Cooperation**

Both parties will be obliged to assist in a reasonable manner with the speedy execution of the benchmarking process.

**Results of Benchmarking**

Benchmarking is useful in indicating macro-discrepancies that exceed a reasonable threshold of approximately 10 percent in target pricing to market. The benchmarker will use a peer sample of more than five data points to arrive at a mean market position. The following actions will take place as a result of the benchmarking process:

- A benchmark shall have no impact if it indicates 10 to 15 percent or less variance from the mean.
- If a benchmark indicates more than 10 to 15 percent variance from the mean, then the service provider shall eliminate the variance to bring it to the range of 10 to 15 percent of the mean, provided that the service provider shall not be required to reduce its prices by more than 15 to 20 percent.
- The price reduction shall be applicable retroactively to the date at which the benchmark was commenced.
- If the service provider refuses to reduce its charges, then the client may choose to terminate the benchmarked tower(s) for zero to 50 percent of the applicable “termination for convenience” charge.

**ELEMENTS OF A BENCHMARK CLAUSE**

TPI believes that benchmark data can be used more effectively when benchmark clauses are better written and implemented. Parties must understand both the make-up and limitations of benchmark data, which have been described previously. Detail is crucial in any contract document, and the clarity of all elements is vital. Negotiation does, however, necessarily involve a “give and take” process, which especially entails considerations about some key clause elements. Some tips on where to place emphasis in negotiating a useful benchmarking clause are set out in the following table.
<table>
<thead>
<tr>
<th>Element</th>
<th>Consideration</th>
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<tbody>
<tr>
<td>Benchmarking frequency</td>
<td>The right to benchmark too early, too widely or too frequently in a contract should be weighed against the actual value this might bring and the overall intent of the clause.</td>
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| Benchmarker qualifications | All partners must adopt the rational practice of carefully considering some important qualification criteria that benchmarkers must meet before they perform a formal benchmark.  
  - Important criteria are:  
  - Independence  
  - Proven methodology  
  - Proven access to relevant data |
| Benchmarking process    | When negotiating clauses, clients should avoid over-prescribing the benchmarking process and standard of measure. Most often in practical operation, the parties must take into account what the benchmarker can actually perform, rather than what was written.  
  Key areas to consider are:  
  - Statistical basis for comparison  
  - Definition of “peers” |
| Results of the benchmark | Overly aggressive clause negotiation can result in wording that is either unworkable in practice or contrary to the original intent of the benchmarking provision. Key areas to consider are:  
  - Setting a reasonable threshold (supported by the limits of the data).  
  - When determining that a discrepancy between benchmark and contract pricing should trigger a change, base the decision on what the data can realistically support  
  - Set a reasonable maximum limit on how much a service provider’s price must change in the event of a discrepancy. Becoming overly aggressive in this area can often result in a failure elsewhere in the clause, which can prevent a workable benchmark.  
  - TPI’s experience with clients suggests that – if there is a price discrepancy – unless highly specialized services are being provided, the benchmark clause should make absolutely clear the course of action (or choices of action) that can remedy the situation. Merely agreeing or planning to discuss the situation has often proven unsatisfactory. |
SUMMARY AND CONCLUSIONS: TPI’s POSITION ON BENCHMARKING

TPI’s position on benchmarking is a fair reflection of commercial structures in place and the reality of available data in today’s outsourcing marketplace. This position recognizes that the objective of the contractual treatment of benchmarking is to provide a mechanism that fairly addresses major shifts in market pricing over long-term agreements. Achieving this objective may appropriately take different forms, depending on the nature of the services, maturity of the market, availability of data and other relevant factors.

The traditional use of formal, structured benchmarking is not necessarily appropriate for some specific services and for some shorter contracts. The appropriate approach to structuring a benchmarking clause will depend on the facts and circumstances of the contract, including client requirements. A benchmarking clause should minimally give the client the right to benchmark and to require full cooperation from the service provider.

Clients and service providers who are armed with market data can, in some client situations, negotiate appropriate adjustments to align with the market. The client can ensure fair negotiations by also deploying its other contractual levers – insourcing, re-sourcing, termination for convenience or non-renewal. In other situations, some clients will require a more structured clause that includes a prescribed outcome (or automatic adjustment). Certain principles should be applied to ensure the fairness and efficacy of this more structured approach.

When applied, formal, structured benchmarking must be built on a realistic foundation – the processes involved are specified and reasonable limits on the outcomes expected. Effective benchmarking must be fair, equitable and supported by the quality of the underlying market data available – data that today is not suitable for the micro-analysis of pricing or statistical precision.

TPI believes that, on the whole, the changes to a benchmarking approach that TPI promotes will better position and inform the industry to make benchmarking more of an effective contract tool and less a source of tension in outsourcing relationships.

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Looking for a strategic partner? Contact Michelle Volk at +1 214 205 4992 or michelle.volk@tpi.net.
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