BENCHMARKS

Customers expect value for money. Pricing established by competitive bidding should, they believe, remain competitive throughout the contract term. No surprise there, although they may not fully appreciate the calculated risks suppliers run by proposing long term prices based on anticipated efficiencies. How then to square the circle and meet customers' reasonable expectations while preserving acceptable margins?

Many customers propose 'most-favored' pricing, as if they were buying commodity products and services. Outsourced services, alas, are not pork bellies, soybeans or even commodity services like laundry or catering. Outsourced services enabled by technology are sold in a dizzying array of combinations. Even if the data were at the supplier's fingertips (it's not) 'apples-to-apples' comparisons are virtually impossible; and periodic certificates of compliance confer no practical benefit upon customers, even if backed by intrusive audit rights. For these reasons, 'most-favored' pricing is a non-starter (unless required by law, as for some government customers). Sophisticated advisors to customers regard 'most-favored' clauses as 'trade bait,' readily conceded in favor of reasonable rights to benchmark charges (and perhaps service levels) against the current market.

Suppliers accept benchmarking as a market reality. Though rarely invoked (for cost and other reasons) benchmark clauses give customers leverage and, since they could squeeze revenues and margins, they invite vigorous negotiation. Contentious terms include the following:

- ***By whom?*** Benchmarkers are commonly chosen from a short list of familiar names that necessarily excludes the supplier's competitors. This much is rarely controversial.
- ***How soon and how often?*** Prices fixed through competitive bidding should remain competitive for at least a year or two. Thereafter, 18-24 month intervals should suffice. In practice, benchmarks occur (if at all) midway through the usual term of five to seven years. Original pricing remains competitive for a time; and benchmarking hardly merits the effort and expense during the last year or two before expiration or renewal.
- ***Who pays?*** Customers often propose to pick and pay the benchmark firm. Some suppliers accept this; others prefer joint engagements at joint expense, in order to have a say as terms of reference are framed and the process unfolds. Outcomes may largely depend upon the skill and professionalism of the benchmark professionals, and the quality of the information they receive from the parties. By offering to pay, suppliers assure themselves a seat at the table, believing that views expressed during the benchmark exercise may be more persuasive than any critique of draft findings.
- ***Scope?*** Customer-oriented forms often allow the customer to pick, choose and then benchmark subsets of service, even individual line items. Suppliers call this cherry-picking, noting that restaurant guides commonly compare prices of entire meals, rather than *à la carte* prices for soups, salads, *hors d'oeuvres*, desserts or drinks. Suppliers commonly insist, and most customers agree, that benchmarks must examine all services, or whole categories of service, rather than line items, unit charges or rates.

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- ***Price or Price and Service Levels?*** Customer-oriented forms also tend to permit benchmarks of both charges and related service levels. In practice, since the two are related, doing so introduces circularity into the analysis. More stringent service levels, with shorter response times, narrower margins for error, more staff and greater redundancy will (not surprisingly) cost more. In practice, since customers are far more likely to benchmark price, suppliers often live with rights to benchmark both (so long as service levels are considered in normalized comparisons).
- ***Process.*** Benchmark firms have, and participants usually live with, standard methodologies for collection and review of data. However, the parties may supplement those procedures by providing for nondisclosure obligations, mutually agreed terms of reference, commitments to copy all parties on communications with the benchmark professionals and an opportunity for both parties to comment upon a draft report before findings are set in concrete. None of these refinements need be controversial, if phrased succinctly. None need slow the process or make it more cumbersome, but they may help to keep suppliers informed and assure that they are heard, in order to help prevent errors and aberrations.
- ***Normalized comparisons*** are essential, and, in principle, rarely controversial. All understand that any comparison must account for such variables as scale, geography, 'financial engineering,' transitional arrangements and charges, asset or personnel transfers and service levels, among others. The choice of comparators may be more contentious. Usual issues for suppliers include sample size (larger is generally better) and use of near-current contracts with peers (rather than bargain-basement alternatives or adjusted cost data for customers' internal operations). When sample sizes are larger, outliers are sometimes disregarded. Unusual or uneconomic terms should also be disregarded (eg, discounts based upon volumes of unrelated business).
- ***Standards for comparison*** are often contentious. Customer-oriented forms often call for suppliers to offer top quartile quality for a bottom quartile price – in other words, Tiffany quality for a Walmart price. Suppliers prefer to peg comparisons to the median or average of a sample and within a reasonable margin for error, given the uncertainties of a process that involves limited data sets and subjective adjustments. Only if charges for benchmarked services exceed a reasonable threshold above the middle of the benchmarked sample should the customer have recourse to any remedy.

Remedies. Many customers propose that their suppliers match rates determined by the benchmark firm. Few suppliers muster much (or indeed any) enthusiasm for this prospect, which is sure to reduce and could eliminate margins. Nor will they agree to retroactive adjustments, which compound the pain with accounting complexities. The accountants may decline to recognize revenue in the first place, rather than risk later restatements of earnings. Occasionally, suppliers will agree to make modest, prospective reductions, not to exceed a modest, single digit percentage. More often, they will agree to meet with the client to discuss benchmark findings and possible adjustments to the scope, solution, service levels and price in hopes of finding an acceptable compromise. For suppliers, the crucial point is to examine benchmarked service as a whole, seeking opportunities to reduce costs as well as price and so preserve the essential economic arrangement. Price is not an independent variable. If the parties are unable to agree within a reasonable period, measured in weeks and not months, the customer may terminate for convenience, perhaps for a reduced termination charge – a prospect thought to motivate flexibility.