ARTICLE

UNDERSTANDING PRICE BENCHMARKING

in Human Resource Outsourcing

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Understanding Price Benchmarking in Human Resource Outsourcing

EVEREST GROUP RESEARCH UNCOVERS BEST PRACTICES FOR HRO PRICE BENCHMARKING THAT ARE SIGNIFICANT FOR BUYERS.

Navigating the complexity of Human Resource Outsourcing (HRO) can often cause frustration for both buyers and service providers. Specifically, price benchmarking in HRO often results in headaches rather than serving as a constructive tool for negotiating service prices in light of market norms.

This is according to a recent report by Everest Group titled, "Navigating Complexity in HR Outsourcing Price Benchmarking". The report highlights that price benchmarking, if not carried out in a structured and well thought out way, can lead to significant value erosion.

In order to utilize price benchmarking to their benefit, buyers need to have good insight into the factors that affect the price of commercializing their HR functions.

Pricing models used in outsourcing

The two most common pricing models used in outsourcing are output-based pricing and input-based pricing, also known as the FTE based model. Despite output-based pricing seeing a gradual increase in adoption, FTE-based pricing still retains the lion's share of overall outsourcing deals for now.

What differentiates output-based pricing from a more traditional FTE-based approach is the way in which business volume is linked to buyer spend. In this model the buyer only pays for jobs done or transactions handled. This links the fortunes of the provider with the success of the buyer's campaign in a shared risk scenario. A number of factors specific to the buyer's HR environment are taken into account under the output-based model, and this not only makes for accurate pricing, but the provision of an effective tailored solution. On the other hand, FTE-based pricing is a fairly standard approach based on a employee hours with a particular combination of skills and location.

The added luxury of the output-based model is the removal of resource efficiency management from the buyer. However, the implementation of this model is a bit more complex and requires an accurate prediction of transaction volumes to be able to price effectively.

Due to these challenges, the output-based pricing model is not the most popular choice for most outsourced functions – particularly those that are new to outsourcing. However, in terms of percentage of contracts using the output-based model, HRO reflects the highest adoption with other business functions showing a low adoption of this model. Almost all the deals signed in HRO include output-based pricing due to providers typically managing and supplying technology, which gives them greater control over process management and the subsequent required output. Additionally, HRO originated in payroll outsourcing, which was historically priced on an output model of per-payslip-processed.

Price drivers

There are a number of factors upon which accurate output-based pricing is dependent. Buyers need to consider each factor to understand how their HRO contract price will be negotiated. According to the report, these factors include:

- Outsource scope: These are the processes and supporting technology selected to be moved to an outsource provider.
- Technology ownership: The ownership of assets required to deliver the outsourced service
- Technology type: The technical requirements and technology needed as well as the quality of selected technology to deliver solutions.
- Offshore leverage: The mix of onshore and offshore delivery centres to get the optimum skills spread and cost savings.
- Deal type: This refers to whether the deal would be a single process or multiple process HRO.

- Volume: The extent to which sub-processes are included in each process stream.
- Industry vertical: The industry in which the buyer functions and operates

The report notes that with each of these factors, there is a degree of risk for potential price prediction errors. For example, the outsource scope has the ability to alter costs by 10 – 15%. Then, the deal type – whether single process or multi-process HRO – can change the costs from between 10 – 20%. Should the ownership of technology be factored incorrectly, it could result in a potential cost benchmarking error of 5 – 15%. More notably, when taking all factors into consideration, a net potential benchmarking error of -100% exists. This highlights the importance of buyers fully understanding the way in which pricing is derived and benchmarked, in order to avoid error and value erosion.

How pricing is derived

The report suggests a four-step price benchmarking approach for providers which, if understood by buyers, can mitigate the risk of potential benchmarking errors.

Step 1: Understand the buyer's environment

The purpose of this step is to collect all of the relevant information needed to understand the outsourcing environment. These data points include; geographies in scope, deal type, number of buyer employees and volume of transactions as well as the process specific factors.

Step 2: Identify comparable deals

By means of factors unique to the buyer, comparable deals are identified to benchmark costs. Due to the uniqueness of the client solution and the outsourcing environment as a whole, finding identical deals may not be feasible.

Step 3: Normalise data

By making use of survey-based benchmarks, findings could be misleading due to insufficient data points, strict criteria and the lack of contextualization. To address this, buyers need to review as many deals as possible to normalize the data collected.

Step 4: Conduct benchmarking analysis

The final step is to interpret the normalized pricing data. According to the report, it is best to compare the current prices to the median benchmark value, without the low and high-end datasets. This results in a narrower range of comparable pricing. When the interpretation is concluded, buyers will be able to establish whether the current pricing is higher than the benchmark which can be addressed through renegotiation. In addition, buyers will also be able to establish whether any saving opportunities will exist at all.

HRO price benchmarking is not a straightforward effort and buyers are often daunted by the task. This ultimately results in their reluctance to commercialise their operations. However, should price benchmarking be approached systematically, the overwhelming element thereof can significantly be removed and possible value erosion avoided through ascertaining real savings opportunities.

> "FTE-based pricing still retains the lion's share of overall outsourcing deals for now."

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