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Viewpoint<

Outsourcing

The 5 golden rules

Procurement outsourcing is big business nowadays, with more and more organisations handing over responsibility for managing parts of their external spend to a third party. This, however, has sometimes proved problematic.

Once the dust has settled, many companies are left feeling they have failed to achieve the best possible deal with savings and/or service at levels lower than anticipated.

However, this does not have to be the case and there are numerous examples of successful cases where both high service levels and savings have been achieved. This depends on whether certain fundamental issues are taken into account. There are some fairly simple rules that, if followed, can produce a successful procurement outsourcing deal and these are explained in the five key points below.

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1. Gain full visibility of your spend before embarking on an outsourcing deal

Outsourcing is often seen as a way of getting rid of a problem. The first areas of spend more frequently considered for outsourcing are those which are seen by the company as low priority. But precisely because they have historically been of little interest, detailed data on these areas of spend is often very limited. The temptation is to pass the problem to someone else who will take responsibility for it and, at the same time, generate savings that will far outstrip their fees.

Be warned: this approach will not pay off in the long run. An initial lack of spend visibility makes it impossible to benchmark any results achieved by outsourcing, making it impossible to set up a fully transparent deal with the outsourcing provider. You will never know if you have maximised the full savings potential.

The best way forward is to make the investment needed to achieve visibility on all interested areas of spend and make a savings potential assessment upfront so that savings can be properly measured and benchmarked.

2. Decide what you want to outsource and what you want to keep in-house

One of the key factors that determines customer dissatisfaction in procurement outsourcing is a mismatch between the outsourcing agreement and the real company "needs and wants".

There are several options open to a company wanting to outsource its procurement spend. These are essentially determined by three key criteria.

First, the level to which the company wants to retain responsibility in defining the strategy for the outsourced spend. Giving the outsourcer freedom to define category strategy is a good option if one of your key objectives is to minimise your resource input. It is also recommended when the outsourced spend has little or no synergy with your in-house activities, and where an outsourcer can offer opportunities for innovation. With the right boundary conditions, this can ensure that savings are identified more quickly than when a company retains involvement in the procurement strategy.

The second factor to consider is which steps of the procurement process are going to be taken on by the outsourcing provider. Most companies opt for the outsourcer managing the whole process as this requires less of their own time and effort.

Limiting the outsourcing to the sourcing element only, without the ongoing contract management, is only recommended for organisations in which sourcing and contract management are two distinct functions, performed by different people, often in separate organisations. This is common in organisations where the sourcing function is positioned within procurement while contract management is located in the business unit. In other situations, the company should re-consider whether the right answer to its requirements is a sourcing project rather than an outsourcing deal.

The third factor to consider is whether responsibility for transaction management is going to be retained in-house. Keeping transaction management within the company is the logical choice when a change would constitute an efficiency loss rather than a gain. This is the case when the outsourcing is focused on a limited number of categories and the transactional aspects are already efficiently run in-house or when they are difficult to disentangle from a broader process, for example when they take place in a shared services centre. Moving transaction management to the outsourcer, however, can work well when the outsourcing is across a complete range of categories and includes all spend.

3. Keep ownership of your contracts

In most outsourcing arrangements, contracts can be negotiated and closed in the name of the "parent" company doing the outsourcing. Conversely, procurement outsourcing specialists may argue in favour of linking deals for specific categories with several of their clients into a single procurement framework under their management.

It is strongly recommended that companies retain contracts directly with each of their suppliers so that full transparency is maintained and it is easy to evaluate and benchmark costs at any time as part of a performance assessment. It also means there is a guarantee that all benefits achieved are transferred directly to the organisation thus achieving full visibility on the total cost of the outsourcing services.

Additionally, savings are maximised because important levers such as specification rationalisation, demand management and process improvement can only be successfully applied based on a company's specific situation and full control on the supplier payment process is kept, avoiding the risk of credit issues.

Companies with a sizeable spend should also consider that they already have the critical mass to leverage volume benefits, so by joining a framework agreement it is likely that they will simply find themselves subsidising other smaller participants.

4. Demand full transparency

One of the main reasons for bad experiences with procurement outsourcing is that many companies accept price mechanisms and contract conditions that give them limited visibility on costs and make benchmarking very difficult.

To avoid this, it is important that full transparency is clearly specified as a "must" and not as a "nice to have" right from the start, in the RFI and RFP phases of the outsourcing deal. This should cover the total cost of the service and its components.

While being open to different approaches for providing cost transparency when supported by a sound rationale, "black box" pricing in which the internal workings of the deal are invisible, should never be accepted.

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5. Define a clear commercial strategy

Outsourcing providers can be asked to present both a fixed price and a contingency-based offer. However, this makes comparisons more difficult. A fixed fee may produce a better deal than a contingency-based arrangement when the outsourcer has performed well and over-delivered results. But it is relatively more expensive if there has been under-delivery.

The number of possible pricing scenarios can be greatly reduced by asking all suppliers to quote according to the same pre-determined pricing models.

Either way, any commercial strategy should be based on a clear view of the preferred risk profile - failure to do so can end up with your business customers feeling they have been delivered a bad deal.

The key questions for a procurement executive planning to enter an outsourcing deal are:

- How confident are you in your estimation of the benefits that might be achieved?
- Which key risks do you want to protect your company from? For example, do you want to pay for under-delivery, or are you prepared to pay a higher fee in case of over-delivery?

If an outsourcing specialist has provided a transparent pricing model at its estimated mid-point savings, the no-risk fixed fee will be lower than the price in a contingency option in which the outsourcer bears a degree of risk.

It must be known in advance how much "risk premium" is charged by the different suppliers for a contingency model and if this can be considered worth paying.

Finally, know how much, more or less, the charges will be in each contingency option in case of under-delivery and over-delivery. Supplier price ranking may be different for different models. The answer to the above questions determines which price model to go for and which price ranking is the most relevant to your company.

In short, be prepared

Outsourcing is often a difficult area to get right and has been, in many cases, heavily weighted towards to the service provider. However, it does not have to be this way and the key is to know your spend, be fully aware of the terms and conditions, ensure you have full transparency and be prepared to monitor. This isn't something that can be forgotten about, it is still a supplier contract and must be managed as one.

Efficio is a management consultancy focused entirely on procurement and supply chain optimisation.

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