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APPROACHES TO SOURCING SERVICES

The strategic sourcing approach to procurement has been around for many years and has been applied to categories from paper clips to heavy earthmoving equipment, and most categories in between. It is typically delivering benefits in the range of 5-15% over all categories combined.

When executed well, strategic sourcing is an excellent means to bring expenditure on indirect goods and even raw materials under control, and therefore remains one of the most important tools in a procurement professional's kitbag.

Having observed the power of strategic sourcing methodologies demonstrated on indirect inputs and sometimes raw materials, the question often posed within organisations is: "How can strategic sourcing approaches be applied successfully to the procurement of services?"

Critical differences in the nature of what is being supplied and the economics of services firms mean that a modified approach is required to successfully apply strategic sourcing approaches to services.

This article is a brief discussion on the nature of services procurement (particularly the associated uncertainty) and a high-level perspective on approaches that have proved to be effective in sourcing service categories.

CHARACTERISTICS OF SERVICES

Complexity, lack of information, perceived risk, difficulty in tracking benefits and unique business economics are all drivers of uncertainty in services procurement.

COMPLEXITY

When buying services, organisations are selecting an individual or group of individuals who possess intangible skills which must then be applied to an existing web of interactions within an organisation.

This is a significantly more complex 'product' and buying process than for indirect items, like paperclips. A paperclip can be completely, or at least sufficiently, specified, by four or five measures - material (2 or 3 specs), size and weight, number per box etc. But the services of an engineer, programmer, barrister, auditor or consultant are much more difficult, but by no means impossible, to specify.

LACK OF INFORMATION

In many cases services requirements cannot be fully specified until the job is partially complete. For example, the engineering requirements for a major pressure vessel refurbishment remain unclear until the vessel has been shut down and inspected, or the balance of legal skills and experience required to support an acquisition will often change as unforeseen circumstances emerge in the deal process.

Perversely, this level of complexity and incomplete knowledge often leads not to more information on providers and their performance, but to less. For example, large manufacturing companies will often have a well defined procurement policy and process for indirect inputs like stationery, with requirements documented, specifications known and supplier performance measured to multiple KPIs, but at the same time have almost no procurement or supplier management system for engineering and maintenance contractors, no explicit selection policy, and few ongoing quality measures or risk management processes.

One reason that increased complexity leads to lack of information is that more complex service categories are regarded as the domain of experts - engineers, lawyers or accountants - and procurement professionals are excluded from participation in the selection and ongoing supplier management process. Another reason is that the risk and cost of changing suppliers is deemed to be too high.

PERCEIVED RISK

Unsurprisingly, risk is closely associated with the other sources of uncertainty surrounding services procurement. High levels of uncertainty and a lack of explicit selection and management process mean that relationships with implicit measures and high levels of trust dominate. A typical response to an inquiry about the selection of a particular service provider is: "We use firm X because we have done so for many years and they have always done a good job".

In the short term, challenging these relationships may appear unwise, however some risk needs to be accepted (and managed) to ensure firms can continue to benefit from a healthy and competitive services market.

Unfortunately the longer term result of seemingly risk averse behaviours is to actually increase the risk associated with provision of those services, resulting in a lack of market depth (skills shortages), lack of firm / plant knowledge held in the marketplace and over-reliance on one or a few providers

Increasingly, with sustained growth in the Australian economy (and other factors which will not be discussed here) impacting the supply and demand balance for skills, organisations must work to become the customer of choice for scarce technical service skill providers. To achieve such a status, organisations need to create a new focus on defining requirements, measuring performance, and regularly testing the market to ensure that service providers selected continue to represent the best value the market can provide.

It is also important to consider value and risk assessments in relative as well as absolute terms. A poorly chosen legal team may result in a failed litigation defence, costing the firm millions, so in absolute terms the risk is great indeed. However it is worth considering whether the selection of the best legal team available may have resulted in the same outcome, in which case the relative value difference is much smaller.

DIFFICULTY IN BENEFIT MEASUREMENT

The simple equation to measure strategic sourcing benefits for goods, $\text{benefit} = (\text{old price} - \text{new price}) \times \text{quantity}$, is too simplistic to give a true picture of performance for services.

In the case of services procurement, the price (or hourly rate) is often less important to the total cost than the quantity, or number of hours. In fact one cynical contractor commented to a colleague during a negotiation: "OK, you tell me what you want the rate to be, and that's what we will give you!", knowing that any reduction in hourly rate could be more than covered by extending the length of the job. Basic demand management tools are thus a prerequisite to successful services sourcing.

Not only is unit price, or rate less important to the total value picture for services, but any analysis of total cost of ownership (TCO) must include scope for additional value add, which in the case of more complex and customised services is significant.

UNIQUE BUSINESS ECONOMICS

Buyers' perspective: Basic economics tells us that the most efficient market is 'perfect competition', many providers and an undifferentiated product. In short, wherever possible, more suppliers are better than less, and a less unique and better described requirement is preferable wherever possible. The problem is that to deliver value-adding services, providers need information, for example, plant knowledge and experience or knowledge of firm culture, insight into strategic growth plans, etc. Much of this sort of information is sensitive and / or costly to collect and disseminate, hence 'many providers' may not be a realistic option.

Service providers' perspective: Service businesses have a very different cost structure to a manufacturing (or goods-based) business. Fixed costs are generally a much smaller proportion of the total costs for service businesses. The corollary is that volume aggregation to a lower price, but higher total margin to the supplier, which is one of the main drivers for efficient purchasing, is no longer available. The most critical driver

of profitability for a service business is not total volume, but utilisation. So a single large project, while interesting to service providers, is likely to be fundamentally less profitable in the long term than an ongoing stream of work of predictable size and scope.



Figure 1 : Strategic sourcing approach – simple services

APPROACHES TO SERVICES PROCUREMENT

So much for the issues, what about the solutions?

Non-strategic services, where value added and risk is limited (eg. office cleaning services) can be sourced using a similar approach to commodity indirect goods.

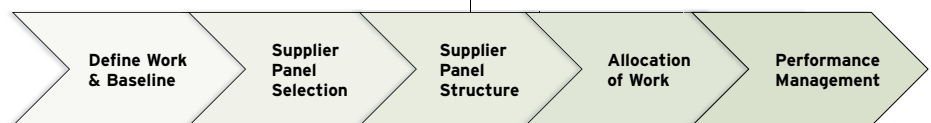


Figure 2 : Strategic services approach – complex services

This represents the well-established strategic sourcing process which includes a detailed specification of requirement and current spend, harnessing a competitive market and awarding of the business to a supplier or suppliers for a (usually) fixed price and term.

By contrast, strategic services, where either value add or risk is assessed as high, need to be approached differently.

Creating a panel of preferred suppliers and a structured environment in which they can compete for the available pool of work, and be recognised for value delivered above and beyond a competitive price, represents a fundamental change in the sourcing approach.

Essentially a panel structure deals with the issues of uncertainty by deferring the final allocation of work until more information is available. A structure is also created for measuring performance and overall value added. In addition an environment for collaboration and the managed entry of new suppliers is developed.

DEFINING REQUIREMENTS

The starting point for sourcing of services is to build a picture of existing and forecast service requirements. Services then need to be carefully grouped into categories within a hierarchy that is skills based at a high level and task or activity based at

subsequent levels. This process of defining requirements is critical to engaging both experts in particular service categories, and decision makers in the organisation and is common to both simple and complex service category approaches.

Having defined requirements the next step is to determine how the provi-

sion of a particular service adds value to your business, and what level of uncertainty is inherent in both the long and short term in supplier selection and management processes. Creating a dialogue with an extended stakeholder group is a useful way to test the level of uncertainty and risk implicit in current purchasing patterns.

The result of such a process will be a matrix of value and uncertainty ratings against each service category that will add enormous clarity to the selection of a suitable approach to each service.

Wherever possible historical usage patterns must be used to create units of work for repeatable, but not necessarily predictable work. Wherever work can be "unitised" in this way, a simple services procurement approach can be followed.

SUPPLIER PANEL SELECTION

Selection criteria should include measures of capability and competitiveness against the required services. The performance measures used should form the starting point for ongoing performance management within the panel.

An appropriate panel structure is vital to success for a number of reasons. Firstly the size and composition of the panel must match the requirement. If the rules for work allocation and performance measurement can't be generally applied and are subject to regular exceptions or the quality of service declines, the integrity of the panel will be threatened.

Sufficient internal resources need to be allocated to the administration and governance of the panel to ensure communication is adequate and that the structure and rules are understood and followed.

A fair and transparent process for the allocation of work with the panel must be created, including an exceptions process to manage the limited number of work packages which need to go outside the panel.

PERFORMANCE MEASUREMENT

Explicit measures for performance must be included in the panel management process. Criteria and weightings need to be determined allowing for minimisation

of risk and delivery of increased value. A simple and transparent process to collect and communicate these measures must be designed and implemented.

Competitive tension is maintained at two levels. Firstly, within the panel providers will compete for large project work as it arises, and secondly, a clear process exists for entry to and exit from the preferred panel based on performance.

As a counterbalancing force to naked competition, panel members are brought into a closer relationship with the buying organisation through improved communication of requirements, both timing and scope of impending work, and better communication of performance assessment.

OUTCOMES

Strategic sourcing methods can be applied to services, even complex services via the appointment of a panel of preferred suppliers. Through this panel organisation, collection of performance data and dissemination of requirements

is coupled with a structure that facilitates more efficient competition.

However, this is a small part of the overall benefit. The largest portion of the hard dollar benefits will come through greater competition for 'biddable' work, where a larger pool of qualified suppliers compete for jobs, creating benefits of up to 20-30%. Efficient processes for managing bidding on projects are therefore important, as this will increase the volume of 'biddable' work, maximising the benefit.

Finally, there is a huge benefit to becoming the customer of choice for those service providers measured as being 'the best' in their field. Benefits will come not only by reductions in cost but through significant additional value creation as these providers become strategic partners in your business. ■

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Ronan Carter is based in our Sydney office and recruits Australia-wide. He has over five years' procurement experience in the procurement industry (both in 'line' and consulting roles) in blue chip companies and clients such as Accenture, British Airways and BP. With this knowledge and experience, Ronan specialises in recruiting procurement and strategic sourcing professionals into the financial services, IT, telco and management consulting markets. Recent permanent roles successfully completed include:

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