

Driving Demand Management for Internal Services

The Role of Behavior-changing Pricing in Managing Demand

Faced with stagnant growth and increased competitive pressures, companies in many industries are reexamining their cost structures to extract further savings and sustain adequate margins. This search for step-change improvement sets up a natural contest between line and service organizations, one that plays out in predictable ways. Business units (BUs) complain that they bear the brunt of the belt-tightening and point to support services as a drain on their resources. Support functions point to benchmark studies that show they are performing at best-in-class levels and have already squeezed out potential cost savings. Can they both be right?

In a word, yes. It is true that internal service organizations have become noticeably more efficient and market-oriented in the past decade, thanks to a host of strategic initiatives including business process reengineering, shared services, ERP, and strategic outsourcing. But they have also gained unnecessary weight.

During the 1990s, internal service organizations grew at a rate disproportionate to the growth of their companies. As management focused on meeting growing customer demand, the cost of demand-driven support functions such as Finance, Human Resources, and IT drifted off the radar screen and steadily upward. However, now that growth has stalled, management has redirected its focus to cost reduction – thoughtful, lasting, across-the-board cost reduction. The first place companies typically look to for those savings is their support services.

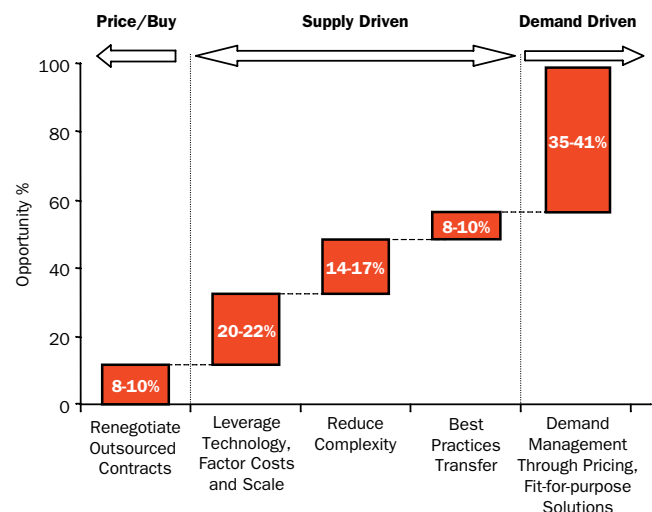
To date, companies have attacked internal service costs from the supply side, applying reengineering techniques to increase efficiency and productivity or leveraging best practices and scale. Our recent client experience, however, suggests that managing the demand for such overhead services yields equivalent benefits (see Exhibit 1). Moreover, there's a greater opportunity in demand management as these techniques have not yet been fully exploited.

The Evolution of Demand Management

For years, support functions were treated as cost centers whose resources were allocated and charged back. Senior corporate executives determined who got what

Exhibit 1

Demand Management Delivers Over 40% of the Cost Benefit



Source: Booz Allen Hamilton

services based on perceived priorities, volume of work, and internal politics. The BUs had little say in the matter.

The shared services model has now largely supplanted the cost center model. Accountability for allocation decisions has shifted down the ladder to the business units and service providers, who now contract for services at agreed upon levels and prices. However, while the shared services model is advertised as a disciplined mechanism for ensuring market-based, arms-length transactions between buyer and seller, it has not always delivered on its promise. Many companies complain that it has not worked as effectively as they had hoped in lowering their costs. Supply and demand for internal services still do not meet at the equilibrium price point. The reasons for this imbalance are several:

- *Lack of “fit for purpose”:* BUs demand significantly higher service levels and/or greater customization than is optimal from a cost/benefit standpoint. Service providers exacerbate the problem by accommodating these requests so as to maintain high customer satisfaction ratings.
- *Misaligned incentive structures:* Service providers are pulled in opposite directions by conflicting incentive schemes. They are directed to satisfy their demanding BU customers, while also driving down overall costs.
- *Weak governance mechanisms:* There is often little to no communication between service and line organizations. Service level agreements (SLAs) serve as a poor substitute for a more active and engaging dialogue.
- *Inaccurate price signals:* To avoid being micromanaged by BU customers and to allow for comparison with external service providers, service organizations set prices that effectively obscure their true cost

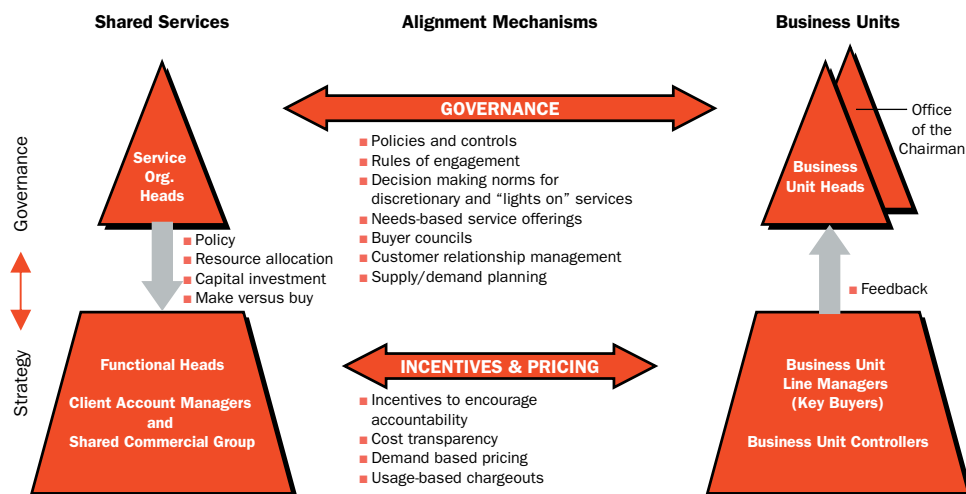
structure. While these prices work for benchmarking purposes, they do not facilitate economic decision-making. Moreover, these pricing methodologies are expensive to manage.

To overcome these obstacles and establish the optimal equilibrium between supply and demand for support services, many companies are implementing demand management methodologies. Effective demand management is not an easy endeavor, which is why it has not been explored until now. It imposes on business units some hard choices. To manage their businesses in the most cost-effective manner, BU managers must make tough trade-offs in the nature, volume, and quality levels of the services that they consume. They must distinguish between “must have” and “nice to have” services. To prompt this paradigm shift, companies need to transform their service delivery model by leveraging three critical mechanisms: 1) pricing, 2) incentives, and 3) governance (see Exhibit 2). The focus of this Viewpoint is on the primary mechanism: pricing. (The others will be dealt with in subsequent Viewpoints.)

A New Perspective on Pricing Internal Services

Prices drive customer behavior and, therefore, are critical to adjusting and balancing demand. Basic economic theory tells us that the optimal price point is where marginal cost equals marginal benefit (i.e., the cost of an additional unit of service is equivalent to the benefit derived from that unit). To arrive at this equilibrium, however, market participants need to understand true marginal costs, and that is simply not the case when it comes to internal service delivery at most companies. Historically, price signals have been inaccurate, obscured, and difficult to decipher. Service organizations sought to recover their costs, and prices reflected

Exhibit 2
Demand Management Mechanisms



that imperative rather than revealing the underlying cost drivers. More recently, in the interest of meeting and undercutting external benchmarks, internal support functions have massaged numbers, often merging fixed and variable costs.

The result? BUs do not understand true marginal costs, resulting in poor price signals and suboptimal resource allocation. Pricing should be a demand management facilitator, not a cost recovery vehicle. That objective is possible only if prices are transparent and provide customers with the levers they need to influence service offerings, costs, and quality. Different services have an inherently different cost structure (see Exhibit 3), and their prices should reflect these distinctions. In other words, the price for every service offering should reveal the breakdown among 1) direct fixed costs, 2) direct variable costs, and 3) overhead costs.

Direct Fixed Costs are typically infrastructure-related and therefore not easy—or even possible—to eliminate or reduce in the short run. Ideally, companies want to maximize short-term demand for such services to increase utilization and reduce effective unit cost. From a demand management perspective, however, there is not a lot companies can do with fixed costs. The budget for these “lights on,” nondiscretionary services (e.g., LAN/WAN, telephone network, HRIS infrastructure) is generally set at the corporate level, and individual BUs have limited input in that decision-making process.

Price signals related to direct fixed costs should not convey to customers the impression of flexibility or even controllability. Products and services that have a predominantly fixed cost structure should be charged out on the basis of historical usage. Service organizations should determine the total costs for these services once a year and maintain the resulting price levels throughout the year, since fluctuations in short-term demand have no impact on fixed costs. This approach should free up resources dedicated to pricing such services.

Direct Variable Costs, on the other hand, do fluctuate with demand. These are discretionary, flexible, and redeployable resources and the prime target of demand management efforts (e.g., help desks, printing services, long distance telephone usage). Service organizations should send business units very clear price signals for these services to reflect their variable nature and encourage a reduction in short-term demand.

Products and services that have a predominantly variable cost structure should be billed out based on the

Exhibit 3
Prices Should Reflect Underlying Cost Drivers



Source: Booz Allen Hamilton

actual cost incurred to deliver that product or service. This sort of flexible pricing mechanism encourages business units to optimize their short-term demand, while forcing service providers to adjust supply levels continually to match that demand.

Finally, *Overhead Costs* are those incurred by the service organization that cannot be directly attributed to the delivery of a service. These costs include management and other administrative functions. The costs for these activities should be separately identified and monitored by an internal services governance body. In the short run, these costs should be treated as fixed and charged out the same way.

Obviously, this discussion oversimplifies the variety of complicated factors that weigh on the pricing of internal services. However, it does make clear the importance of conveying the true cost structure for internal services to the customer.

In addition to exposing the underlying cost structure, service providers need to communicate that information to the customer... at a level where it is “actionable.” If the customer contact is not in a position to make a buying decision, there is little point in billing at that level. Similarly, if a BU manager cannot weigh in on an expense because it is mandated at the corporate level (e.g., corporate security, audit), these costs need not be broken down at the BU manager level. Discussions of those costs should be held at the executive level.

Other Demand Management Drivers

Incentives are closely linked to pricing in driving demand management. As mentioned earlier, too often incentives are misaligned and prompt schizophrenic behavior on the part of the service organization. Motivated to enhance customer satisfaction by service level agreement incentives, service providers lose sight of the bigger picture, which is to decrease overall costs by rationalizing BU demand. To achieve that goal, incentives need to be directly linked to the business units' cost reduction goals.

So as not to strain day-to-day working relationships at the line manager level, these links should be established at senior levels in the service and line organizations, where they are bound to be more effective. Bringing that top-level perspective to the matter of internal service incentives fosters optimization within and across BUs.

These proposed changes in pricing and incentives cannot be effective in the absence of effective

governance. Good governance, at its core, is a matter of communication. By establishing clear, indeed transparent, pricing mechanisms and by motivating the appropriate behaviors, a company will effectively provide the context for an affordability dialogue.

Demand management can be institutionalized only if both BUs and service providers are held accountable. Many companies set up boards to serve as a governance forum with participation from both line and service management. These boards act as a primary interface, providing directional oversight and customer input to the service organization and serving as a BU sounding board and platform for service delivery standardization. This cross-functional team provides the vehicle through which true customer segmentation and fit-for-purpose solutions become reality. The governance board also serves as a forum where cost and service level issues can be resolved. Again, good governance sets the stage for a genuine affordability dialogue and reinforces the alignment of supply and demand in internal service delivery.

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