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Optimizing Internal Demand

Third-Generation Service Delivery

In recent years, as top-line growth has stalled, companies have had to get creative about cost reduction. As always, they are looking first to pare expenses in internal services. What is different is the lens they are applying; the perspective has broadened. Instead of relying solely on supply-side tactics to cut costs (e.g., process reengineering, automation, outsourcing, offshoring), companies are now managing the *demand* for internal services as well, challenging both service providers and business-unit customers to make serious affordability and service level trade-offs. Our experience suggests that effective "demand management" can unleash "next-generation" savings gains of 5%-15% (see Exhibit 1).

Demand Management 101

Demand management complements and reinforces supply-side gains by encouraging and, ultimately, institutionalizing a better alignment between the supply and demand for internal services. Given constrained budgets and service prices based on the provider's actual cost-to-serve, what would business units choose to buy? What are their "must-have" services? What is "smart to have"? Where will they make trade-offs?

Exhibit 1

Typical Range of Administrative Cost Reduction Potential by Type of Function

	SHARED SERVICES VALUE DRIVERS			
	Supply-Side Restructuring	Demand Management	Price/Buy	Total
IT	15-20%	10-15%	5-10%	30-45%
Staff Functions	8-23%	5-7%	2-5%	15-35%
Customer Care Back Office	7-15%	5-8%	3%	15-25%

Notes:
IT includes: applications development; mainframe/desktop/servers; network infrastructure
Staff functions includes: finance; HR; purchasing; legal; facilities
Customer Care Back Office includes: contract administration; contact/call centers; billing; reporting
Source: Booz Allen Hamilton

While simple in theory, in practice internal demand management is anything but, as it requires profound behavior change on the part of both buyer and seller.

Despite recent efforts to make internal service delivery more marketlike, most service providers and their business-unit customers still have not moved beyond menu design and order taking to active collaboration.

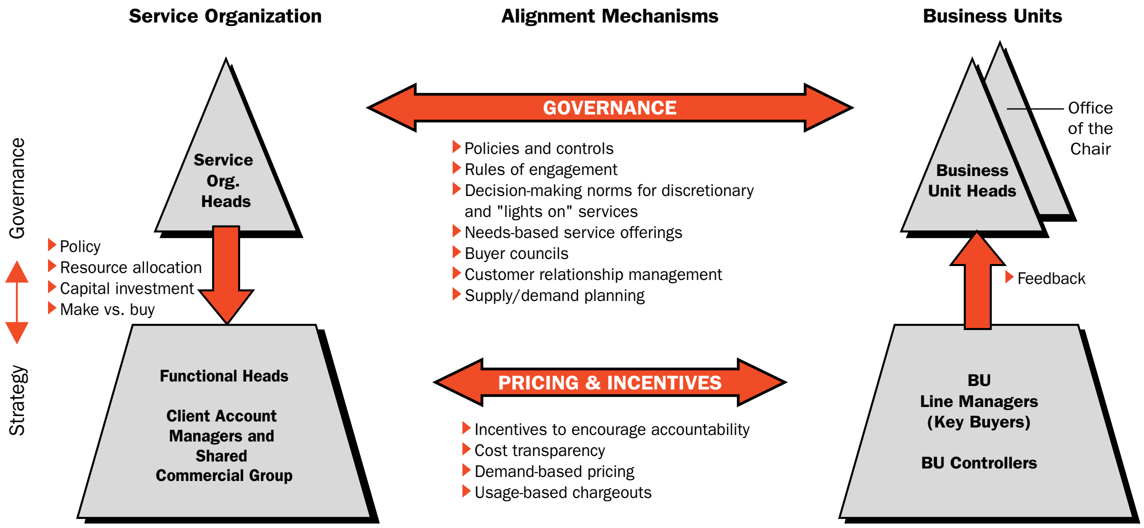
Moreover, pricing presents challenges. Demand management hinges on true and transparent price signals based not on an allocation or cost recovery formula, but on an accurate assessment of underlying cost drivers. Many businesses fear that the administrative and accounting mechanisms needed to establish accurate price signals will add more complexity than discipline. In fact, our experience shows that many companies can develop effective pricing mechanisms using a simple spreadsheet.

To overcome lingering resistance and facilitate a more economical service delivery model, we propose a demand management approach that focuses on three interdependent levers (see Exhibit 2, Page 2):

1. **Governance** mechanisms to ensure that end users and service providers communicate expectations and concerns fully and regularly;
2. **Pricing** signals that accurately reflect a service provider's underlying costs and allow end users to make sound economic decisions;
3. **Incentives** that encourage end users and service providers to make the right affordability trade-offs.

To be effective in exploiting these levers, internal service delivery models need to evolve, as Exhibit 3 suggests:

Exhibit 2
Demand Management Levers: Governance, Pricing, and Incentives



Source: Booz Allen Hamilton

1) ***First Generation:*** Get the basics right
2) ***Second Generation:*** Drive true behavior change
3) ***Third Generation:*** Establish collaborative partnerships

First Generation: Get the Basics Right
During this initial phase, management blocks out the structural elements of the internal service organization and addresses customers' fundamental questions: What am I buying? What does it cost? What choices do I have to reduce these costs?

The most common mistake companies make in setting up service organizations is failing to establish sufficient and effective governance systems and procedures from the outset. Getting the basics right includes:

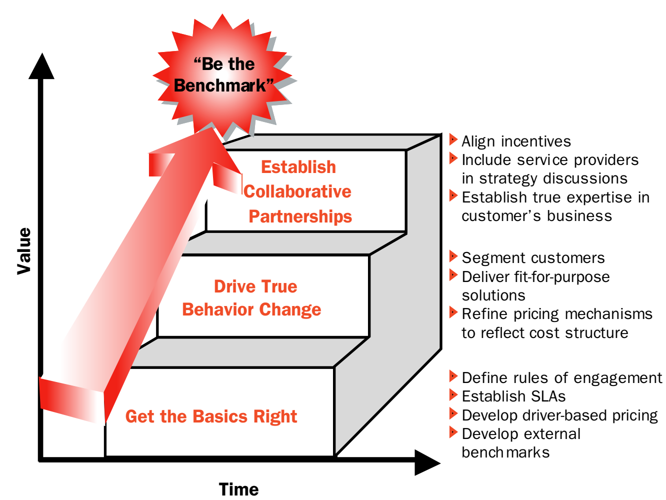
Governance:

- *Service level agreements (SLAs)* are contracts between buyer and seller that stipulate the types, amounts, and performance levels of services to be offered at predetermined price points.
- *Buyers' councils* are forums in which senior stakeholders from both the service organization and the business units can communicate and resolve issues. Often such a forum already exists within a company and these issues simply can be added to the agenda.
- *Rules of engagement* should spell out key processes and procedures such as variance accountability and methods for dealing with costs mandated by the corporate center. Moreover, management should also make clear the rules of *dis*engagement under which a business unit can decide to outsource a particular service. These rules should detail how stranded costs should be treated and provide for an oversight process to ensure that the entire company's best interests are being served.
- *External benchmarking* helps service providers identify useful supply-side efficiencies, justify costs to business-unit customers, and maintain a rigorous, continuous improvement focus.

Pricing & Incentives:

- *Cost driver-based pricing* conveys to the buyer the true costs of the service provided. To derive this figure, service providers must identify a reasonable set of cost drivers for different services and develop the discipline to measure these drivers consistently and regularly. Moreover, service providers need to find ways—as external suppliers do—of reducing costs (and prices) over time. Pricing is critical to effective demand management; if done right, it serves as a communication vehicle to help modify buying behavior—not as an invitation to needless complexity. The trick is to build pricing from an easily measured set of drivers that make sense to both the service organization and the business units.

Exhibit 3
Evolution of Internal Services Organization



Source: Booz Allen Hamilton

- *Incentives* should induce service providers to simultaneously reduce costs and improve customer responsiveness. Service provider incentives can be based on regular customer satisfaction surveys as well as annual cost reductions or, alternatively, on how costs compare to external benchmarks.

Second Generation: Drive True Behavior Change
Annual service level agreements alone may be sufficient for commodity-type services but not for services adding greater value. If the initial stage of the journey is all about getting the right structural elements in place, this second stage is focused on some of the "softer" skills involved in customizing service offerings to fit the unique requirements of each customer.

Governance:
- *Top-down affordability analyses* allow companies to put the tenets of demand management to the test. Presented with constrained budgets and "true" costs for internal services, business units are compelled to prioritize services into:
  - *"Must haves":* Activities that must be performed because of legal and regulatory requirements;
  - *"Smart to haves":* Typically, control and risk management functions;
  - *"Nice to haves":* Discretionary activities that allow business units to improve performance, build capabilities, and create competitive advantage.

  Top-down affordability analysis serves as a good forcing function; it prompts an affordability dialogue that leads to a better alignment of supply and demand (See Case Study).
- *Fit-for-purpose solutions* are the "happy medium" between a standardized, "one-size-fits-all" offering and completely customized solutions. The goal is an efficient range of semitailored services for distinct segments of demand. Previously overserved customers can reduce costs, while the company reduces its overall cost-to-serve.

Pricing & Incentives:
- *Refined pricing mechanisms* allow the service provider to communicate more than total cost; this way components of the cost structure become clear. Different services have inherently different cost structures (e.g., fixed vs. variable, sunk vs. incremental), and their prices should reflect these distinctions. Transparent pricing equips customers with the levers they need to influence service offerings, costs, and quality. In fact, to simplify the process and to make it actionable, the pricing detail provided to a user should be tailored to the level of control the user has on the spend.

Third Generation: Establish Collaborative Partnerships
The final stage in the evolution of internal service delivery is the metamorphosis from cost-competitive supplier to expert and trusted partner. This is not a subtle shift; it involves a complete change of mind-set for both provider and user. This transformation begins with the following steps:

Governance:
- *Customer relationship management* skills help service providers develop a true partnership with the customer. The service provider needs to dedicate credible senior talent and specialized capabilities to the relationship and establish true expertise in the customer's business.
- *Participative decision-making* means that service providers are included at the table during business-unit strategy sessions. Moreover, providers should be consulted in acquisition and divestiture decisions. To build a true collaborative partnership, both service providers and their business-unit customers need to understand one another's strategic requirements and make business decisions with these in mind. To foster this level of collaboration, incentive schemes need to reward business partnering.

Pricing & Incentives:
- *Aligned incentives* help keep service organizations properly focused. Too often, incentives are misaligned and prompt inconsistent behavior from the service organization. Motivated to enhance customer satisfaction, service providers lose sight of the equally

Case Study: Affordability Analysis

Recently, in the midst of a demand management program, a Fortune 500 client participated in a prototype affordability analysis to prioritize internal services according to those services' perceived value to users. The services were classified as "Must Haves," "Smart to Haves," and "Nice to Haves."

The corporate functions were asked to assess the "Must Have" and "Smart to Have" services, while the "Nice to Have" services were analyzed by the business unit users. Starting with nothing, both groups were asked to build their preferred portfolio of internal services based on three scenarios: 1) an unconstrained budget; 2) a 30% reduction in total service costs; and 3) a 50% reduction.

Charged with minimizing the impact to their operations, participants classified activities as "Eliminate Completely," "Reduce Usage," "Reduce Service Level," or "Maintain Usage and Service Level."

While no activities were completely eliminated, several were scaled down in usage and service levels (e.g., desktop support, management reporting, budgeting and planning, recruiting, organizational planning and HR consulting, internal process consulting, construction project management).

The identified reductions in usage and service levels translated into a 25% cost reduction opportunity.

important mandate to decrease overall costs by rationalizing business-unit demand. To achieve the desired focus, incentives for senior management in the service organization need to be directly linked to the business units' cost-reduction goals, as well as to efficient and effective service delivery.

This evolution in internal service delivery is swiftly—and necessarily—gaining momentum in an environment of slowing revenues and tighter belts. As one company put it: "We have to provide value-added service. We are constantly being asked to cut costs and eventually we will disappear. We have made very explicit decisions to move up the value chain, otherwise we would have remained in the overhead category and been cut."

The ultimate goal for internal services is to move from commodity, cost-based service provider to business-enhancing, trusted advisor. By the third generation we've described, internal support functions will offer not only cost-efficient services, but also value-added features and benefits that will enhance business-unit performance. While few firms have reached the destination, the tools and processes are slowly taking hold. Service providers can now engage business units in a collaborative discussion of their actual needs and suggest alternative delivery mechanisms that will help firms to which they cater be more effective. Substantial gains are not far behind.

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