Process friction: the killer weakness in contractor procurement

Why the friction factors in contractor efficiency are costing you much more than you realise

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Introduction – a flawed model

The use of IT contractors is widespread across all industries, with huge amounts of budget being allocated to project-based and temporary staffing. This paper arises because organisations put far too little thought into how efficiently they hire and deploy these contractors. The traditional approach is focused on crude input measures, of how many individuals are hired and how much they cost and not on the value based on the business benefits or delivery outcomes.

In fact, the efficiency of any contractor model is hugely influenced by friction factors whose impact is profound but not well-recognised. The issues of Utilisation, Churn, Wage Inflation, Miscasting, Knowledge Leakage, Inflexibility and Unfilled Roles all combine over the length of a project to have a detrimental effect on contract output. This paper discusses what these true impacts are and how they affect productivity, with cost figures aggregated from industry experience and academic reports, to provide you with the means to assess how much they are costing your organisation.

Friction factor one: Utilisation

We know what we mean by utilisation: if an individual works 100% efficiently for 100% of the time, they are 100% utilised. There are a number of factors that impact this rate.

First, of course, no one works that efficiently all of the time. A realistic utilisation is less than 100%. In fact, average utilisation is between 65% and 75%.

Second, there's an arc to utilisation. During the on-boarding and training phase, utilisation is lower than when an individual is up to speed. Likewise, at the end of the engagement or when they are looking to leave, utilisation can decrease as the individual disengages from the role, works on their CV, and attends interviews. It follows, then, that net utilisation goes down in direct proportion to the amount of churn. Conversely, longer-term contracts will yield higher net utilisation.

Third, while an individual may be willing and able to give 100%, internal process delays can leave them waiting for an input and unable to push on with a task. While they are waiting, their utilisation falls.

Fourth, an individual may be unwilling to give 100%. For example, where management oversight is limited, they may be contracted for five years to deliver a project that could be done in three. Their inclination may be to drag their heels and spin the project out for the whole five year term, deeply compromising their utilisation.

Fifth, utilisation also relates to an individual's capacity to do tasks. Miscasting an individual reduces their utilisation, in the sense of their potential value contribution. This happens either when they could perform higher value tasks but aren't regularly asked to do so or when they are struggling in a role that is beyond their current skill set.

Finally, note that permanent staff won't be productive while they're away from work, say at the dentist. Contractors, on the other hand, won't be on the clock while they're not working, so their utilisation isn't affected.

While 100% utilisation is probably unachievable, organisations should actively optimise utilisation all of the time. However, they seldom do so.

How much does it cost me?

Even if utilisation is above average, at 80-90%, the cost is still 2.5-7.5% of your total contractor spend

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Friction factor two: Churn

Churn is staff turnover. The more individuals who leave and have to be replaced, the greater your churn. Recruitment costs are well-recognised, but the true cost of churn is not well understood. Nor is the fact that churn can be addressed.

The costs of churn

Many people believe that the cost of recruitment is the agency fee to find a replacement. In fact, the true cost begins with the underperforming individual who is either on their way out or doing so poorly that they need to be replaced. Typically the underperformance is protracted before the situation is tackled, so the organisation suffers the cost of the job not being done efficiently or effectively, probably for several months.

The organisation then selects, hires and briefs an agency, reviews a shortlist of candidates and brings some individuals in for two or three stages of interviews and testing. All of this uses up management time. And even when the individual is appointed, they may not be available to start straight away.

In the meantime, there's a hiatus when no one is in the role for weeks or even months. Colleagues cover the gap, to the detriment of their own work. This hits productivity, creating a significant opportunity cost for the organisation.

When the new starter begins, there's a learning curve during which they won't achieve full productivity. Moreover, a manager or colleague is often pulled off their own work to help on-board the new person, resulting in another cost to the business.

Depending on the complexity of the role, it can take up to six months for the new person to get fully up to speed. In the meantime, the agency bill is paid and is taken to be the only cost of the churn. In fact the true cost can be extraordinarily high. An HR Director who calculated the cost of churn in his organisation found that between recruitment costs, the need to reassign adjacent staff and most importantly missed Sales opportunities, replacing a single person had cost the business £739,000.

The factors influencing churn

All the above might be seen as a cost of doing business, but actually organisations can address several of the factors which influence churn.

Pay rates, for example, are highly influential in causing contractors to move on. Very typically when a rate is cut, the contractor stays but starts to look for something better. If the rate cut leads to a restless workforce and increased churn, it may be a false economy.

Contractors are hyper-sensitive to rates. Most will set themselves three or six-month earnings targets. They typically stay well-aware of the market rate and quickly recognise if they are working for an organisation that is falling behind. This causes dissatisfaction and increased churn.

Many contractors are nomadic, with relatively little loyalty to the organisation they're working for. They are also driven by the need to build their CVs, which is most quickly achieved by frequent moves. Finally, they are wary of staying too long on one site in case it affects their tax status. All of this makes them more mobile and more likely to cause churn.

To reduce costs, many organisations have also chased cheaper rates in lower-cost economies. Outsourcing to offshore locations can look like a bargain. However, the churn rates are typically much higher. This is because these individuals tend to move jobs much more frequently and for relatively small inducements. In India, for example, churn of 35% is typical. So lower rates both mask the costs inherent in high churn, as well as cause them.

A further cause of churn is length of engagement. When a contract is renewed for a short period, say three months, the individual may accept it but simultaneously starts looking for a more secure longer-term option. In fact, a high proportion of contractors will trade a slightly lower rate for a longer engagement. It's particularly nonsensical to impose a three month contract where the individual will take up to six months to become fully productive. Yet it still happens.

Miscasting is also an element of churn, especially with higher-level roles. Around 10% of contractors are not happy to perform in a role which is below their skill level, even when they are paid at a rate consistent with their qualifications and experience. They worry that they will become de-skilled, that their CV is not going in the right direction, and that they risk being devalued in the market. They may also feel that the job has been mis-sold to them.

All these factors contribute to churn and can be addressed. Organisations can also institute a policy of over-manning to mitigate the impacts of churn, or adopt a model which strips out short-term, piecemeal contracts. A final point is that the weak economy has depressed churn in the last few years, but as the economy picks up it is likely that churn will increase.

How much does it cost me?

Churn can result in a lost time impact of between 10% and 30%.

Friction factor three: Wage inflation

Wage inflation is endemic in contractor relationships. Typically contractors will look for an increase when the contract is renewed. It follows that the shorter the contract, the more frequently the opportunity arises to revisit the rate, which could be as often as three or four times a year. Also the increase in rate is not linked to standard metrics such as economic inflation or increased responsibility but measured by perceived value against their current peers. With longer fixed-term contracts, that can go away.

Contractors who become essential are also in a strong position to ask for a rate rise. As they often feel it's in their best interests to make themselves indispensable, they may not readily share information. Their short-term involvement and the pressure to deliver can also mean they don't document activity as much as someone who is in it for the longer term. Carefully managed knowledge sharing procedures will resolve this.

Finally, wage inflation is often fuelled by supply and demand. There is a need to break the cycle of limited supply and high rates. This can be done by changing the supply model.

How much does it cost me?

Day rate wage inflation can cost between 5% and 10% of your annual contractor spend.

Friction factor four: Miscasting

Miscasting happens when the incumbent is over- or under-qualified for the role they're in. In contractor services is it extraordinarily common that individuals are over-qualified. Quite apart from the part it plays in churn (see above), it represents a very significant cost to organisations when they consistently over-pay people whose full skill-set is never, or rarely used.

Of course a driver of miscasting is the belief that it's a less risky option. But like hiring a brain surgeon to take blood, miscasting puts highly-qualified individuals into roles where they are not using their real skills. In fact, they may not perform as well as someone who is more appropriately qualified for the role. The idea that over-casting de-risks your operation is a myth.

Over-casting also happens when the individual is only occasionally required to perform higher-level tasks. But this is hugely wasteful. A better approach is to aggregate the high-level tasks, so you hire only say one or two highly-qualified, high-cost people to cover your actual need, instead of ten.

Conversely, under-casting can be a result of wage inflation, where the pressure to cut costs leads to hiring a lower-qualified person than the role requires. The inherent dangers of this approach are clear: it results in sub-standard and slow performance.

A final category of miscasting is skills inflation. This is where the individual, who is initially under- or right-cast, gains skills in the course of doing a job, over say two or three years. This is a problem because of the regular rate rises we've discussed. In due course, organisations find themselves overpaying the individual for the role they're in. This can be tackled with more careful management of who is doing what and for how long.

How much does it cost me?

Overpayment can account for between 10% and 15% of total contractor spend.

Friction factor five: Knowledge leakage

Knowledge leakage happens when individuals leave with what they know. Organisations using contractors extensively, and suffering from high churn, will be significantly affected by knowledge leakage. It leads to delays, the redoing of work and lost relationships.

As noted above, many contractors are short-termist and may not document things well. This has to be countered with knowledge transfer procedures that feed into robust induction programmes.

How much does it cost me?

The cost of losing vital operational knowledge and retraining to back-fill can be around 1% - 2% of total contractor spend.

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Friction factor six: Inflexibility

Flexibility is the capacity to reassign tasks and projects as and when required, leading to the most efficient deployment of finite resources. But it's often hard to do in practice. This is partly because of the way organisations structure themselves into small cells, and partly because of the way budgets are allocated and internal politics operate. As a result, organisations find that their ability to redefine tasks or redeploy individuals at a granular level is very limited.

The solution is to step back and take a broader view. In tandem, hire contractors who are willing to redeploy as required. A more flexible workforce will drive higher utilisation across the whole organisation can be tackled with more careful management of who is doing what and for how long.

How much does it cost me?

The inability to reassign tasks and projects results in lost time, and can account for between 2.5% and 5% of contractor spend.

Friction factor seven: Unfilled roles

Specific skill sets are sometimes needed to deliver required projects, but these skills can be difficult to find and resource. Organisations in need of technical and specialist roles will suffer from the inefficiency of unfilled roles when relevant contractors are not available. The scarcity of key skills in specific geographies leads to delays in filling roles, and so delays to the project output

How much does it cost me?

Reduced and delayed output from unfilled roles can account for between 2% and 8% of contractor spend.

The true cost of friction

As we've shown, there are several factors that reduce the efficiency of employing contractors, each of which has a cost. The problem is that to date organisations haven't recognised this fact.

This happens largely because no one is measuring the cumulative impact of the friction factors. As a result, organisations can't see a reason to manage the friction factors out. It's not so much 'what you can't measure you can't manage', as 'what you don't measure, you don't see the need to manage'.

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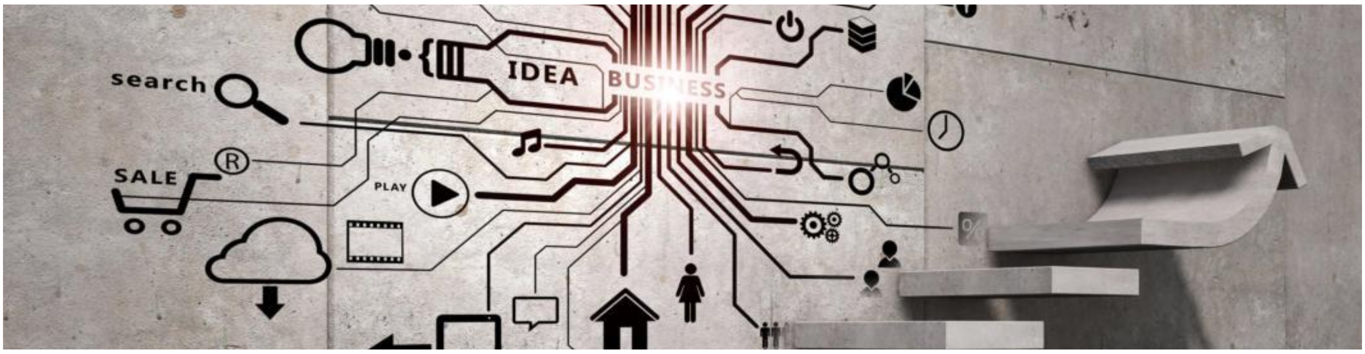
Instead, and to their overall detriment, what organisations do measure, assiduously, are the inputs – the number of contractors they employ and their day rates. Instead the focus needs to shift onto the delivery of outcomes – the cost-effective and timely achievement of the tasks at hand.

Furthermore, measurement isn't as complicated as you might think. It's simply a matter of assessing the extent to which each factor has an impact on your organisation and adding the totals together.

Drawing on Thebes' long experience of contractor deployments, in the following table we've given you realistic figures as to the likely extent of the impact of each factor. So, for example, churn is likely to cost the average organisation using a significant number of contractors between 10% and 30% of total contractor spend.

Factor	Impact	Low	High	Your Organisation?
Utilisation	Lost time	2.5%	7.5%	
Churn	Lost time	10%	30%	
Wage inflation	Day rate increases	5%	10%	
Miscasting	Over payment	10%	15%	
Knowledge leakage	Re-training costs	1%	2%	
Inflexibility	Lost time	2.5%	5%	
Unfilled Roles	Lost time	2%	8%	
Total Friction		**33%**	**77.5%**	
Contractor Efficiency		**67%**	**22.5%**	

This simple table illustrates a worst case scenario: that when all active together, the friction factors very significantly erode the cost-effectiveness and efficiency of hiring contractors in the traditional way. Over the life of a project, the combined effect of friction factors relating to several contractors will drastically impact both the cost and quality of contractor output.



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Summary – Adopting a new approach

It's our experience that organisations typically concentrate on putting in place the technical skills they require to deliver tasks and projects, and then measure how many and how much. Improvements in HR tooling have allowed better measurements and control of certain friction factors but these only dampen the symptoms and do not change the root cause of the problem.

Often feedback processes do not exist between the IT function and HR/Procurement to measure the hidden costs of previous engagements. HR/Procurement do not have the metrics to buy intelligently, and thus can think very little, if at all, about the other factors that influence overall performance.

Meanwhile outsourcing IT contractor procurement to a single external supplier is being used as a blunt instrument to provide quick wins of between 5-10% on headline day rates. Although organisations have had a massive requirement to gain a level of control over their IT contractor supply chain, this approach does not fundamentally impact the friction factors and in many scenarios exacerbates them. Short term gains are lost in the near- to medium-term from the increase of friction, and longer-term benefits are not realised.

This approach leads to gross overspend and a much longer time to value than necessary. Yet the remedy is in our hands.

Organisations should instead be focusing on the required outcomes and the shortest route to achieving them. This can be done relatively easily if they give attention to the friction factors which impact efficiency, and act accordingly. Attentive line and demand management, and the adoption of a better temporary services model – a model that buys project or operational output as opposed to contractor 'input' – removes the risk of financial inefficiencies and leads to higher performance all round.

Historically fixing or tendering for outcomes proved onerous on the procuring organisation and were reserved for larger projects.

In the last year few years, companies IT frameworks have matured their ability to define and procure specific projects or operational requirements on small to medium budgets.

Combined with an increase in trusted boutique Assured Outcome Providers (AOPs), organisations now have the skills to buy intelligently and strategically on a smaller scale than before. Companies should be setting their targets to achieve medium- to long-term savings of between 15-30% rather than the short term 5-10% that is gained from having third party organisations manage IT contractor procurement. More attention to the underlying causes of inefficiency will bring much greater and more sustainable rewards.

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AOP

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Assured Outcome Providers are the new generation of professional service companies that are providing innovative solutions to organisations who have a requirement for temporary services and boutique outsourcing. Using forward thinking business models AOPs are able to engage with organisations in a transparent manner to squash the friction factors and drive efficiencies. Working as a partner rather than a subcontractor AOPs will ensure that Organisations;

- Are assisted in defining service levels or outcomes in a rapid time frame;
- Have the ability to retain IP once any engagement has concluded;
- Can reduce or increase any engagement without lengthy notice periods;
- Can reduce or increase the capacity during the engagement without lengthy change control;
- Can monitor and measure the progress of an engagement against agreed timeframes or service levels;
- Are assisted in providing the feedback loop between HR/Procurement and the IT function; and
- Can reduce inefficiencies in costs and these are underwritten and delivered.

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