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ESO MATURES

Contracting and Pricing Models Evolve for Engineering Services

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ISG WHITE PAPER

INTRODUCTION

The Engineering Services Outsourcing (ESO) market has witnessed substantial growth in recent decades, and has evolved to encompass a broad range of new product development, value-engineering and engineering consulting functions. As the ESO market matures, new contracting vehicles and pricing models are emerging. Specifically, traditional project-focused contracts are being consolidated into longer-term arrangements with broader scope, enabling more strategic focus. In addition, staff augmentation is giving way to more sophisticated shared risk/reward models that are better suited to the increasing focus on added-value functions.

This ISG white paper examines historical approaches to ESO outsourcing and their limitations in today's growing market, and describes how clients and service providers are developing new models to better address evolving needs.

MARKET GROWTH

A growing propensity to outsource.

Market estimates from various sources peg the current spending on global engineering services is around $930 billion in 2012 and is expected to reach $1.4 trillion by 2020, a 50 percent growth in less than a decade.

The total outsourceable spend on engineering services is estimated at $325 billion in 2012 while offshored spend is approximately $100 billion – approximately 10 percent of the total market. Also, the total outsourcing spend on engineering services is estimated to be growing 3-4 times the rate of total spend on engineering – an indicator of growing propensity to outsource. (For more information on ESO market trends, download this recent ISG white paper).

Over the long term, this level of growth cannot be sustained under the conventional staff augmentation and time and material pricing relationships that have traditionally characterized ESO agreements. Today's market requires far more mature sourcing relationships to ensure consistent delivery of services performance and to minimize value leakage through the terms and commitments of the agreement and relationship.

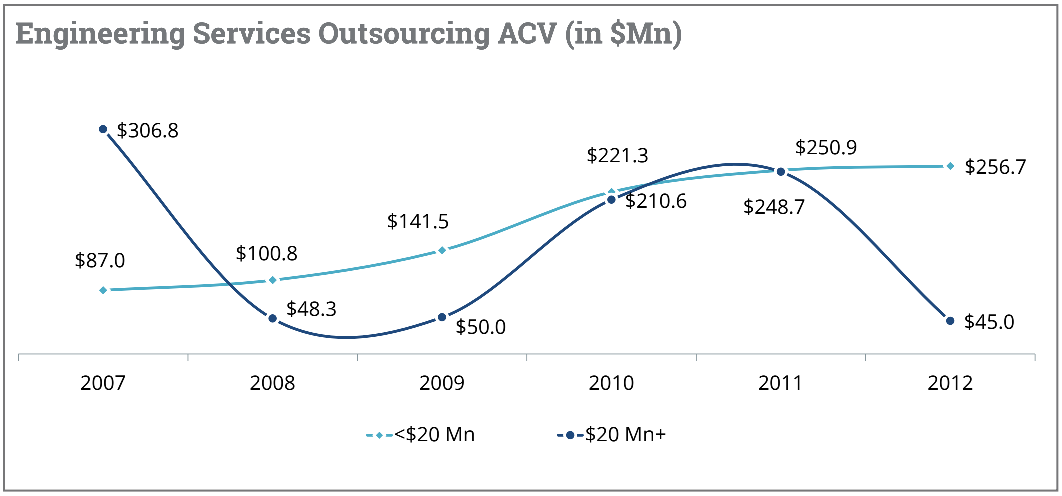
CONTRACT SCOPE AND STRUCTURES

One approach to more mature ESO contracting is to consolidate provider agreements into fewer service providers and into larger and longer term agreements.

ESO agreements have historically been small in annual contract value (ACV) and total contract value (TCV) compared to ADM, ITO and BPO contracts. The term of ESO agreements, moreover, have tended to be shorter than three years as compared to the three-to-five or five-to-seven year contracts that traditionally characterized IT, ADM and BPO outsourcing.

Struggling to manage too many separate contracts.

In the ADM, ITO and BPO markets, ISG has observed a recent trend towards smaller and shorter-term contracts. This reflects market maturity and a growing propensity among clients to develop and manage best-of-breed multi-sourced operating models that leverage specialized capabilities. In the less advanced ESO space, by contrast, small deals of short duration are a sign not of maturity but rather of value-sapping fragmentation. Indeed, ESO clients have traditionally struggled to manage too many discrete, tactical contracts that don't deliver optimal benefits.



The chart above presents two ACV trend lines for ESO contracts. The first trend line represents the total annual contractual value for contracts with ACV of less than $20M. The second trend line represents the total annual contractual value for contracts with ACV greater than $20M. A significant portion of ACV is represented by agreements with ACV of less than $20M, which results in managing too many agreements and supplier relationships.

On the bright side, the historical concentration of high volumes of smaller ESO contracts with ACV under $20M provides an opportunity to consolidate multiple ESO agreements. At this stage of ESO maturity, a redistribution of many smaller ACV contracts with multiple providers into larger ACV agreements with fewer service providers represents a step forward in terms of adding value to clients.

PRICING MODELS

ESO has also lagged behind ADM, IT and BPO services in the maturity of relationship structures and pricing models. The latter sectors have evolved towards shared risk/reward structures, while engineering services continue to be delivered primarily through hourly, daily, weekly or monthly rate-based pricing models, staff augmentation relationships or time and material (T&M) projects of various forms. These less mature resource-based pricing models reflect the conservative nature of the client base; specifically, the lack of sourcing maturity within the engineering services community.

In light of recent and anticipated growth, buyers of engineering services should begin to shift towards more mature and advanced sourcing relationships that will provide more predictable, stable and higher quality of services and deliver the anticipated and contracted value to them.

Evolution and Maturity of Engineering Services Outsourcing Pricing Models & Relationships

Staff Augmentation	T&M Projects	Fixed Price Projects	Services	Risk/Rewards
Current 45% to 23% Future 30% to 10%	Current 40% to 35% Future 30% to 15%	Current 10% to 30% Future 15% to 35%	Current 0% to 2% Future 10% to 15%	Current 5% to 10% Future 15% to 25%
Rate Tables	Time Material	Fixed Price per Scope	Services Pricing	Pricing Aligned to Client Metrics
Direct Fill Staffing	Rate Tables	Incremental rate Tables	Outsourced Services	Outsourced New Product Development
No Scope	Defined Scope	Defined Scope	Defined Scope by System	SLAs/KPIs
No Services	Project Driven	Contingent resources	SLAs/KPIs	

The chart above* represents the evolution of ESO pricing and relationship models, and the current and projected future distribution of partnerships by type. Currently, ISG observes a high concentration of rate-based staff augmentation and time and materials agreements in ESO, versus the risk/reward structured agreements where service providers have financial incentives to achieve business outcomes and hit target service levels and performance metrics.

ISG anticipates a continued shift to more risk/reward structured agreements.

ISG anticipates the continued shift of ESO pricing and contractual relationships from rate-based structures to more risk/reward structured agreements of fixed prices and services-based relationships. This pricing structure shift will be driven by the continued rapid growth of engineering services and ESO globally. With this growth and the continued expansion of service provider capabilities, clients will have more favorable pricing options to consider when evaluating service providers.

**The information presented here is based on ISG pricing structure reviews with engineering services providers, interviews with service providers regarding their engineering services portfolios and contracts, and research into engineering services industry contracts.*

ABOUT THE AUTHOR

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