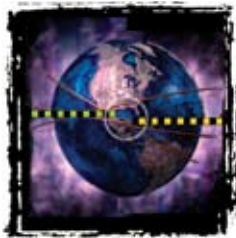


Huge Potential in Contract Labor Substitution

As companies battle to reduce costs and improve cash flow, some are finding that a new approach to contract labor can deliver significant results.

By Mike Hales and Christian Hagen



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One of the most popular organizational and project delivery strategies of the past few years has been to hire contract workers rather than full-time employees. Lower costs and increased flexibility top the list of reasons why. But after riding the contractor bandwagon even for a short time, the benefits can begin to wane. These incremental losses are virtually invisible, quietly sapping cash and compromising organizational efficiency.

There is a way to keep the benefits of contract labor going. It begins by addressing three important questions: Are you reducing labor costs as much as you can? Are you really increasing delivery flexibility as much as you expected? Are you aggressively managing the contractors on an ongoing basis?

One way to answer these questions is to periodically review your labor contracts—particularly for IT functions, which is generally one of the largest buckets of contract labor as well as the most expensive. For companies in industries that rely heavily on IT contract labor—such as financial services, high-tech, and large-scale manufacturing—this is an increasingly large area. By reviewing each large project to determine where (or if) money can be saved, management can squeeze 10 to 50 percent in cost savings.

The savings result from using “contract labor substitution” strategies that more effectively match labor with project needs. Taking

steps such as eliminating unnecessary positions, ensuring that workers are not being overpaid, and bringing some workers on as full-time employees rousts the unnecessary expenses that creep in over the project's duration. Although these savings will not tip the company needle significantly in one direction or another, they do add up. And importantly, they are crucial for a company's overall economic strength.

Usually, the best time to launch a labor review is on the heels of a strategic sourcing initiative. Contract labor substitution picks up where sourcing leaves off. Sourcing focuses on how effectively an organization purchases contract labor by bidding down prices for certain skill sets and supplier mark-ups. (A corollary advantage is streamlined skill sets and preferred supplier relationships.) Substitution concerns itself with whether or not the right combination of skills and resources are in place, a determination often based on new market information gathered from strategic sourcing efforts.

Also, while sourcing should be performed repeatedly to ensure that skills are appropriately purchased, substitution should take place at regular intervals to ensure the project and organization realize the most benefits. Marrying the two approaches can maximize the cost saving and benefits.

Keeping Pace with Change

A large-scale IT project typically has several distinct phases, from design and implementation through user acceptance. While continuity from one stage to the next is important, it's not

often necessary to have the same skills or people in place throughout the life of the project. A software architect, for example, is a critical player at the beginning of a project. But once implementation and coding begin, the parameters shift; keeping the high-priced contractor to do coding is like hiring Springsteen to sing back up. For complex multi-year IT projects, such additional costs can reach into the millions.

Also, just as projects change so do market rates for certain skills. In the late 1990s, companies had to pay top dollar for programmers with SAP and Java skills. Today, the market is saturated with workers with these skills—and the market rate has plummeted as a result. As companies critically evaluate the needed project skills against current market rates, their savings will quickly add up.

Consider the case of a large IT company that each year spends approximately \$2 billion on contract labor globally, with the majority in IT. So when executives were looking for ways to trim costs and improve cash flow, they focused on the biggest areas of their contract labor spend. They drove traditional sourcing strategies to find opportunities to buy services and skills at a lower price, followed by a contract labor substitution analysis. The company has a number of large-scale IT projects that rely heavily on contract workers. But, as is often the case, after a project ramps up and hits its stride, existing labor costs and IT skills were rarely revisited. By taking a second, more critical look, executives discovered that not only were labor costs noticeably above market rates, but a number of positions were either no longer necessary or could be swapped out with less-expensive workers who had the necessary skills to deliver the project. In some cases, it made sense to turn some long-term contract positions into full-time in-house positions.

After thoroughly examining all areas, the company implemented a contract labor substitution program that, coupled with sourcing benefits, saved nearly \$100 million within the first year. The company also established a policy to revisit these projects periodically.

Putting it into Practice

A contract labor substitution strategy is most relevant for companies that outsource IT or other highly skilled—and therefore highly paid—positions. A low-skilled data-entry clerk, for example, may make \$15 an hour. And while it is possible to replace that person with someone who makes \$14 an hour, the differences are negligible. At the higher end of the spectrum, the gap is significantly bigger, which means the opportunities are greater. For example, an SAP

contractor may have been hired several years ago at \$150 an hour. Today, such expertise is more widely available, and the person could be replaced with someone with the same skill set at just \$70 or less an hour (depending on experience and location). In just a few short years, critical skills become more like commodities, and labor practices must keep pace.

To help companies find these hidden savings and streamline their operational costs, we developed the following five-step labor-substitution methodology:

1. Identify key projects. The first step is to pinpoint

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which projects have the largest labor spend by looking at top-down project costs. Best practice companies pull together an assessment team that prioritizes the various projects and reaches out to project managers and key stakeholders of each project.

2. Collect and analyze data. Because this strategy is based on a bottom-up approach, collecting and analyzing in-house data is critical. What positions and skill sets do you have? Look at each of the contractors, their skills and pay. How do they compare with the going market rate? Any gaps between market rates and company terms should quickly become apparent.

3. Identify opportunities for substitution. The assessment team will work closely with project leaders to identify specific areas of substitution. Are there people who are overqualified? For example, is the organizational structure right, or do you have too many senior people and not enough low and mid-level programmers? Does the project effectively match “needed” skills with “actual” skills—could they become full-time employees?

4. Build the business case. Working closely with the project managers, begin building a solid business case and gain buy-in from all stakeholders. While focusing on the bottom-line numbers is important, paying equal attention to business risk at this stage is critical. In other words, don't put \$100 million at risk just to save \$1 million.

5. Begin implementation. Establish a realistic timetable and begin substitution, ensuring a smooth transition and minimizing risk associated with the disruption. In the long term, the assessment team should continue to track benefits and identify additional savings opportunities.