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CONTRACTUAL PRICING ASSURANCE:

Beyond Benchmarking

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ISG WHITE PAPER

EXECUTIVE SUMMARY

Negotiating a large ITO deal presents the thorny challenge of codifying the agreed commercial pricing (usually by service tower). The plethora of pricing models available – such as ARC/RRC, fixed price, T&M, risk/reward, gainshare and cost plus – often creates ambiguity (or "wiggle room"), and increases the risk of the dreaded "value leakage."

While a market price benchmark provides a good starting point for setting the price point boundaries for a fair deal for both parties, we often find that, one or two years into the contract term, pricing disputes arise. These can be extremely time consuming to resolve, can generate tension in an otherwise positive operational relationship between service provider and client, and most importantly can erode the original business case such that the parties become so entrenched in their positions that service delivery is compromised.

This ISG white paper discusses various pricing models, how to ensure actual charges reflect what was intended during commercial negotiations and how to avoid value leakage through good contracting rigour.

COMMON PRICING RISKS

Insufficient attention to how services are contracted for under different pricing models can lead to significant issues for both client and provider. These include:

- Frequent requests from the provider for CCNs or additional funding
- Scope of services delivered don't meet client expectations
- The client perceives the provider as delivering to the minimum level of required quality
- Actual cost of service delivery is higher than the provider estimated
- The client disputes the charges, resulting in a less collaborative relationship

Responsibility for mitigating these risks and applying pricing rigour lies with the commercial negotiator – not legal or finance. Applying the following checklist can help identify potential scenarios and inform a response strategy.

BENCHMARKING

A *market price assessment* by service tower remains an effective mechanism to ensure the original pricing offered is competitive with the market based on a similar set of services. As many factors can influence a benchmark, gathering as much data as possible is essential. In some instances, normalising the data may be necessary where there isn't a like-for-like comparison to ensure that the benchmark results are valid. Since most tier 1 service providers use data to validate their bids, clients who fail to leverage benchmarks can find themselves at a disadvantage. Even where pricing targets are set, knowing the market rates is very helpful as a reference point.

A *benchmarking clause* that allows charges to be benchmarked during the contract term can help negotiate tower-based pricing. However, remember that a clause only ensures the unit charges or rate cards remain within competitive tolerances, but does not mitigate the risk of value leakage due to other factors.

GENERAL PRICING CONSIDERATIONS

Use of Client Premises – Many providers build a "seat charge" concept in to their rates. If a client is providing office space and facilities, then pricing should be reduced accordingly.

Service Credits – When negotiating a percentage for "fees at risk," most providers will factor this risk into their overall pricing. Clients should consider if this is preferable to a lower rate in the first place.

Minimum Revenue Commitments – Some providers will offer favourable discounts on daily or unit rates in exchange for guaranteed revenues. For clients who know they will spend a minimum amount each year, this can be a useful incentive to reduce charges.

Volume Discounts – Where no MRC is in place (or for revenues exceeding the MRC), introducing a volume discount mechanism can be beneficial. This can be offered in terms of a rebate or credit, as a discount on next year's service charges or as an investment in additional effort or services at the provider's cost.

Financial Engineering – When the service charges have all been agreed, it may help to explore the provider's appetite to amortise certain up-front costs (e.g. transition) through a financially engineered model.

CURRENCY AND INDEXATION

Currency Adjustments – currency considerations are essential for organisations that receive services in different countries, as currencies used for purchasing and invoicing services can vary by geography. Clients will need to set prices either in a *single standard currency* (usually USD, GBP or EURO) or in multiple currencies at an agreed exchange rate. As foreign exchange rates fluctuate, consider *at what point you make the conversion* (at time of purchase, delivery or invoice). A common practice is to set an *annual conversion rate against a single base currency*; subsequently, future charges can be budgeted for all locations. Under this method, the parties will be taking some risk against an unfavourable currency movement, so financial advice is critical and sometimes an organisation will wish to *hedge a currency* up front if they believe the movement will go in a particular direction.

Indexation – as services can be provided from different countries and in different client currencies, indexation rules can have a big impact on actual pricing. For example, a service being delivered primarily from offshore will often have a higher rate of wage inflation than in the US or UK, so fixing charges in USD or GBP builds in protection against offshore wage inflation, as the currency movement should be favourable to the provider. However, when charges are fixed in an offshore currency and then converted to another currency for invoicing, inflating the charges based on offshore indices is logical. When modelling a business case, test various combinations of indexation and currency adjustment to gauge the impact on overall deal pricing.

PRICING MODELS AND HOW TO MAKE THEM WORK

ARC/RRC Pricing – Establish the *precise circumstances that would trigger additional or reduced pricing*, not just unit volumes outside of the deadbands. For example, if using ARCs/RRCs for service desk pricing based on ticket or call volumes, the first step is to establish the cause of a sustained period of ticket volume growth. Was it preventable by the provider? Should it have been foreseen? Was the baseline data accurate? These variables should all be covered in the contract. Before agreeing to specific pricing based on this method, run some "what-if" test scenarios to see what impact they would have on the pricing.

Rate Cards – we can spend weeks negotiating what appears to be a very competitive rate card, only to find later on that the delivery team comprises a “top heavy” skills pyramid, or that the effort expended was greater than estimated, each of which increases the real price of the work. Agreeing a *set of role profiles* for each grade and creating a rigorous and transparent *estimating* process can significantly reduce this risk. Sometimes providers will offer a blended rate (usually for offshore resource). While the simplicity of this option can be appealing, consider that under this approach the provider is incentivised to use lower skilled resource to maintain a higher margin. In some instances, a “triple blended” rate (a single rate across roles and onshore and offshore locations) can incentivise the provider to transition more work from onshore to offshore over a multi-year period, by having that rate reduce accordingly year-on-year.

Fixed Price Projects – Ironically, most procurement functions and budget holders still favour fixed price projects, even though they account for most disputes. A simple formula can be used that equates to the likelihood of a dispute:

Probability of pricing dispute = 1 – (Scope Certainty% x Risk Assurance%)

where *Scope Certainty* is the percentage of unambiguous scope and *Risk Assurance* is the accuracy of potential known risks. If both indicators are 50% there is a 75% chance of a price dispute. To reduce this possibility, a good provider practice is to share the risk contingency through a pre-agreed maximum percentage and to have a shared risk register showing which risks fall within “risk contingency,” and which would be considered a change control. This will focus both parties on trying to confirm scope and make adequate provision and mitigation for known risks. Agreeing the work breakdown structure and skill mix required up front for each high value project is also advisable.

Payment milestones are another key commercial consideration for fixed price projects where no fixed or core/flex resource pool is in place. Agreeing payment milestones for long projects (a year or more) can have a big impact on client cash flow and influence provider behaviour. At a minimum, outstanding payments should never be less than the current level of client risk. Provider fixed costs should be covered but payment milestones should be set at critical quality gates where the risk profile can be evidenced as reducing. For large software development projects, the majority of payment should be retained until after user acceptance, with a further lesser amount to be retained until after project closure following a successful “early life support” or “stabilisation” period.

Fixed Price Managed Services – As with fixed price projects, the key here is to ensure the scope of services and *expected outcomes* (including performance targets) are detailed in the contract or statement of work. For a “run” service, the client will want to get the best service for the lowest cost. Typically, most providers will also want to deliver the best possible service but at the highest margin.

If a big disparity exists between the client's and provider's cost expectations, a provider-generated *resource effort breakdown* showing the effort required to deliver the agreed scope to the stated performance levels can be helpful. A *parametric estimating model* can allow the client to scale up or down the scope of services and the level of performance required (e.g. providing 24x7 support for business critical applications but only 9x5 for standard applications).

If neither an agreed estimating model nor an accurate benchmark are in place, the parties may design a more for less model where the service charges reduce over time and either the provider reduces headcount (and therefore cost) or frees up resource to work on other things (improvements, innovation, projects, etc.). A provider who is able to reduce the effort required over time can agree to a lower price up front but with an incentive for the provider to lower its costs over time, thereby gaining from any additional margin.

GAINSHARE AND RISK/REWARD

Gainshare – This is often used where the provider is prepared to invest time to demonstrate the ability to deliver business value (e.g. via an innovative solution or to reduce client costs by leveraging its own third-party commercial relationships). Gainshare initiatives may be co-funded by both parties at an agreed ratio, with the gainshare element then distributed at an agreed ratio (they do not need to be the same). When using gainshare, ensure that the value gained by the client can be clearly measured and that the time period for receiving benefit is established. Where one or both parties have made investments up front, these investments should be recovered first before any gain is realised.

Risk/Reward – Similar to gainshare but where the provider is rewarded financially (usually via some form of fixed bonus payment) for achieving an agreed set of outcomes, while assuming the risk of a low or zero margin for non-achievement. This type of pricing should be considered only when the outcomes are unambiguous, achievable and can be measured by both parties. Getting the balance right between the risk and reward elements is crucial. The approach is not an exact science, so for a provider to adopt such a model the potential rewards should outweigh the risks.

CONCLUSION

The tips outlined here can help avoid "value leakage" from contracts and enable client organisations and service providers to work together to achieve the positive outcomes identified at the beginning of the agreement.

ABOUT THE AUTHOR

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Based in the UK, Gary has over 30 years IT industry experience, the last 10 involving strategic IT outsourcing. He is recognised as a thought leader in pricing principles and deriving maximum value from outsourcing engagements and has helped many of ISG UK's clients negotiate successful contracts. Gary passionately believes in helping both client and provider achieve shared positive outcomes and enjoy a lasting sourcing relationship.

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