



Business Process Services

White Paper

Risk Mitigated Outcome Based Pricing:

A Vehicle to Drive Transformation

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Abstract

The concept of outcome based pricing is not new. There are a number of examples in various industries where providers choose to charge their customers not for products or services delivered, but based on how well they meet the expected outcomes. An example is Rolls-Royce's 'Power by the Hour', where a customer pays for the replacement of engines according to the number of hours the engines have been in use before down-time, rather than paying only for the replacements of parts, consumables, and related labor charges.^[1]

This concept can also be applied equally effectively to BPS engagements for business transformation. Such engagements typically drive fundamental changes in an organization through the use of technology, resulting in topline growth and/or bottom line improvement. However, given the depth and breadth of such engagements, they are subject to risk. Correlating the pricing of such an engagement with the results of the program or solution can therefore greatly ease a client's concerns. This model of sharing gains is very attractive to the provider as well. Typically, even at the end of a large, complex transformational program, a BPS provider stands to gain only a fixed professional fee, based on time and material or resources utilized. An outcome based pricing model is thus a win-win for both parties.

This paper discusses the business drivers for using outcome based pricing in critical BPS engagements. It draws up a model of pricing using aspects of outcome based pricing and 'option' pricing to give providers a competitive edge. We have termed the new pricing mechanism - Risk Mitigated Outcome Based Pricing. The paper discusses how the proposed model can be used to price 'transformational' contracts, lists various scenarios where it can be leveraged, and concludes with a discussion of factors critical to the success of such a pricing engagement.

[1] Rolls-Royce plc, 'Rolls-Royce celebrates 50th anniversary of Power-by-the-Hour', October 2012, accessed May 2013, http://www.rolls-royce.com/news/press_releases/2012/121030_the_Hour.jsp

Contents

Introduction	5
Risk Mitigated Outcome Based Pricing Model in the Context of BPS	5
Pricing Transformational Contracts Using Risk Mitigated Outcome Based Pricing	6
What to Watch Out for: Factors critical to the success of Risk Mitigated Outcome Based Pricing	8
Conclusion	9

Introduction

As IT and BPS providers move up the value chain, businesses are increasingly considering them as strategic partners in large transformation programs. Such programs aim to achieve the desired business outcomes of the customer organization with minimal risk and cost implications.

Organizations are deeply impacted by the success or failure of their IT projects. For a transformational IT program, the level of risk is proportionate to its expected impact. As the global economy recovers, plans for renewed IT investments are being drawn up by CIOs. At the same time, learning from past failures of large IT programs is likely to make them more cautious towards large investments. While partnering with clients on transformational programs provides several advantages to service providers, it is important for them to mitigate their share of risks and costs. An outcome based pricing engagement is more likely to ease a CIO's decision to invest, and assure BPS providers that their efforts will be rewarded proportionately, resulting in a win-win for both.

While engaging a service provider to deliver a transformation program, there are two options for pricing the service:

- **Traditional Fixed Price (FP) or Time and Material (T&M) billing** that includes a pre-defined margin over the actual cost incurred in delivering the service. In this case, the cost is in proportion to the number of provider personnel engaged in delivering the service and the duration of the engagement.
- **Outcome based pricing** usually involves billing that is similar to FP or T&M billing, with an added clause that the provider shares both the results and the risks with the client. Sharing gains can be through a predetermined bonus or a direct share in the benefits of the project. In case the business outcomes are not realized, the provider usually does not pay a penalty. BPS providers often avoid such contracts because of the greater risks involved, especially in large transformation programs.

In addition to these models, we propose a way to create a third option for billing, which mitigates the risk for service providers, provides them with a mechanism to acquire a share in the gains of a successful program, and creates the possibility of generating revenues beyond traditional contract pricing. The client on the other hand can pass on some of the loss to the provider in the event of a failure. This proposed pricing mechanism is based on concepts used in financial options pricing and contract law. We have termed this pricing mechanism – 'Risk Mitigated Outcome Based Pricing'.

Risk Mitigated Outcome Based Pricing Model in the Context of BPS

Our model is similar to a 'call option' for financial instruments. A call option gives the buyer the right (not the obligation) to buy a stock or any other instrument at a specific price within or at a specific time. This specific price is called the 'option exercise price' or 'strike price' (X). There is a cost (C) that an option buyer (in this case the provider) has to pay to buy the option. If the actual spot price of the instrument during the exercising of the call option is 'Sp', then the pay-off can be expressed as shown in Figure 1. The figure also shows how the attributes of the call option can be mapped to a risk mitigated outcome based pricing contract.

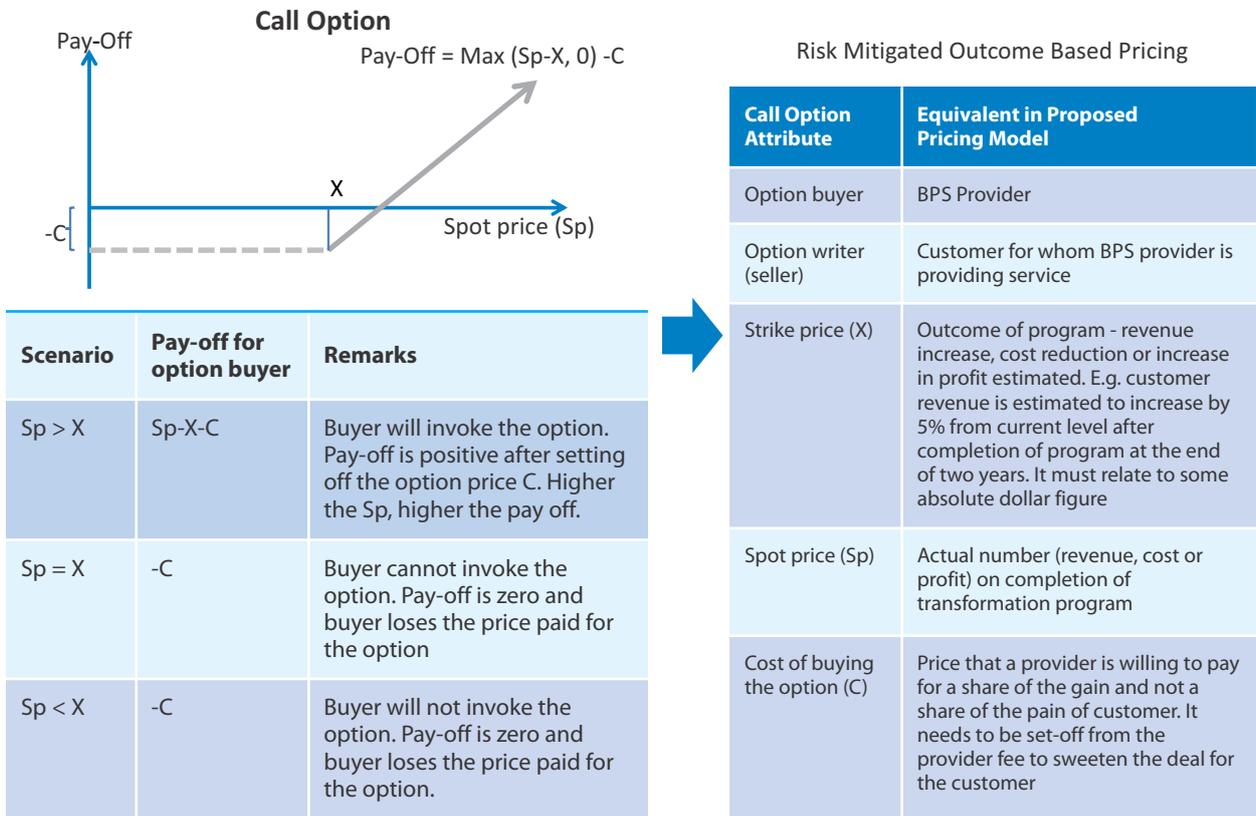


Figure : Pay-off in a call option and equivalent attributes of a risk mitigated outcome based pricing contract

Pricing Transformational Contracts Using Risk Mitigated Outcome Based Pricing

To explain the pricing structure using the proposed model, consider two important outcomes, 'program success' and 'business success'. Program success is measured in terms of quality, timeliness, and acceptance of service delivery by the client. Business success is measured in terms of revenue, cost, profit, and productivity, as well as the favorable impact of the program. The pay-off is positive when both program and business success are achieved. Otherwise the service provider will have to absorb the cost of 'C'.

This implies that the cost 'C' of this option, to share in the benefits but not the risks of the client, plays a key role in the pricing. Service providers can gain a competitive advantage by sharing the client's risk as well, while using risk mitigated outcome based pricing. Let's assume that:

- A service provider is expecting a revenue of \$ Z million from this transformation program from a two years fixed price contract. Under normal circumstances the provider would bid for the contract with Z. However, since the client is looking for outcome based pricing, the vendor will build in an additional margin (say Δ) to mitigate the risk of failure. So the provider is likely to bid at \$Z million + Δ .

- The competitors of this service provider use the same operating model and equivalent cost structure, and hence will submit competitive bids.

In this situation the provider can use the proposed model to gain a pricing advantage, mitigate risk, and ensure profits from the success of the transformation program. Here are the guidelines to compute the pricing in a risk mitigated outcome based pricing model:

- Reduce the normal price to $[Z + \Delta - C]$. This will ensure that the price is more competitive.
- Secure a call option contract on business success locked at the strike price 'X'. This is a better deal for the client since the service provider is offering a discount of 'C' and also, in a way, creating contingent interest in the success of the program.
- Since this is the equivalent of a call option, the downside for the service provider is restricted to only a loss of 'C'.

These considerations can create a win-win situation for the provider and the customer.

It now becomes critical to answer the question: 'How do we estimate C?'

Estimating 'C': Arriving at the cost of buying the option

There are various proven financial models to evaluate an option premium (such as the Black Scholes model^[2]). However, these models are for financial market instruments, where it is assumed that the price of heavily traded assets follows a geometric Brownian motion with constant drift and volatility. The business success parameters (except for the stock price of a listed company) of a firm does not satisfy these criteria. Therefore, we have modified this approach to calculate the option price.

The actual revenue increase depends on various critical success factors (CSF) such as the global economic environment, industry conditions, business dynamics, and emergence of new competitors. Internal factors such as changes in the management of an organization can also affect the success of the transformation project. Any estimation of 'C' must take into account all such information.

Revenue can be projected using the statistical technique of 'Expected Value Pay' (EVP) assuming discrete probability distribution. This simply means assigning a probability to anticipated outcomes. The pricing expert must have a sound understanding of the economy, the industry, and the client's business, and should be able to take a position on each anticipated outcome. The rationale for assignment of probability for all levels of CSF should be documented. Once the EVP is estimated, the pricing expert has a reasonable estimate of 'C'. The expert's position on the pricing can be interpreted as follows:

Proposed C \leq EVP calculated	Proposed C $>$ EVP calculated
Conservative and risk averse pricing: The pricing expert believes that the future is uncertain and reasonable prediction is difficult	Aggressive and risky pricing: The pricing expert believes that the future can be predicted with reasonable accuracy

The price equation of a transformation under risk mitigated outcome based pricing now is:

$$\text{Price} = Z + \Delta - C$$

[2] Developed by Fischer Black and Myron Scholes in their paper- 'The Pricing of Options and Corporate Liabilities', first published in 1973 in the Journal of Political Economy.

While, the final revenue of the provider in risk mitigated outcome based pricing can be modeled as:

$$\text{Revenue} = Z + \Delta - C + R_{\text{shared}}$$

Where:

Z = Regular price the provider would charge in an FP or T&M model

Δ = Premium charged by the provider for accepting the risk of outcome based pricing

C = Discount (equivalent to the cost of the call option) given to the client for entering into a risk mitigated outcome based pricing contract

R_{shared} = Part of the shared revenue of the client or bonus from final outcome (where $R_{\text{shared}} \geq 0$)

What to watch for: Factors critical to the success of Risk Mitigated Outcome Based Pricing

Profitable return from risk mitigated outcome based pricing depends primarily on the extent of business impact that the outcome produces. For instance, in the example discussed previously, the greater the increase in client revenues, the larger the share of the provider. However, since the final outcome often depends upon factors that cannot be controlled by the service provider, there is significant risk involved. It is also necessary to quantify the final outcome in monetary terms that can be invoiced. To do this, the provider and the client must agree upon metrics that can be easily measured. It is therefore important and easier to define the final outcome in terms of business metrics such as operating cost and revenue to ensure the successful application of outcome based pricing (including the proposed risk mitigated model).

Needless to say, such initiatives always require a high level of trust in the client and buy-in from senior leadership of the client organization. There are other factors that play a key role in the success of a risk mitigated outcome based pricing engagement. The final outcome of the engagement may depend on external factors such as major market upheavals or extenuating natural events, which are beyond the control of both parties. Such factors need to be identified and addressed during negotiations under a 'force majeure' clause. Other factors include:

Governing law of the contract: For global organizations that function across multiple national jurisdictions, the impact on business metrics may have a global spread. In such situations, it is critical to choose the correct governing laws (or contract laws), and ensure proper legal jurisdiction and compliance. Legal teams of both parties should carefully review all such contracts.

Dispute resolution: The contract must also outline dispute resolution mechanisms, in addition to the recourse available under the normal court of law. This can be a simple mechanism like setting up a joint committee of experts from both parties, or the inclusion of a formal clause for arbitration.

Conclusion

Organizations today look for strategic partners in their transformative journey. BPS providers on the other hand, are seeking opportunities to add greater value to their customers and transition into the role of 'true partners'. Risk mitigated outcome based pricing contracts can ensure a true win-win situation for clients and providers. On the one hand, customers get an upfront discount and are assured of the provider's best effort in execution. On the other, service providers realize greater revenue and reduce the risk of penalty in partnering with clients in large transformation programs. 'Risk mitigated' outcome based pricing can help providers move beyond fixed price FP or T&M billing to a model where billing is proportionate to the effort and complexity involved, as well as to the impact made on the customer's business.

This model also minimizes the associated risks for both parties. Having a clear understanding about where and how the proposed pricing model can be applied can not only help service providers realize greater value from such contracts, but also imbue clients with a greater degree of certainty about meeting their business objectives.

Even though BPS providers are moving up the value chain, there are currently only a few instances of outcome based pricing, as setting up this pricing model has its share of challenges. It requires the provider to predict future industry and business scenarios, project revenues accurately, conduct careful negotiations with the client, and make intelligent calculations. However, it also brings immense advantages to both providers as well as their clients. Risk mitigated outcome based pricing provides the opportunity for differentiation that is necessary for growth in a near commoditized market.

As clients increasingly consider their BPS providers as strategic partners, services providers should actively look to using outcome based pricing as an effective tool for co-creation of value with the client while minimizing risk.

About TCS Business Process Services Unit

Enterprises seek to drive business growth and agility through innovation in an increasingly regulated, competitive, and global market. TCS helps clients achieve these goals by managing and executing their business operations effectively and efficiently.

TCS Business Process Services (BPS) include core industry-specific processes, analytics and insights, and enterprise services such as finance and accounting, HR, and supply chain management. TCS creates value through its FORE™ simplification and transformation methodology, backed by its deep domain expertise, extensive technology experience, and TRAPEZE™ governance enablers and solutions. TCS complements its experience and expertise with innovative delivery models such as using robotic automation and by providing Business Processes as a Service (BPaaS).

TCS BPS unit has been positioned in the leaders' quadrant for various service lines by many leading analyst firms. With over four decades of global experience and a delivery footprint spanning six continents, TCS is one of the largest BPS providers today.

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