

INPUT

STRATEGIC MARKET PERSPECTIVE

Pricing and Marketing of Outsourcing Services

U.S. Outsourcing Program

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Pricing and Marketing of Outsourcing Services

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Abstract

The number and diversity of outsourcing contracts continues to grow, and the forecast for outsourcing business is explosive. Information systems outsourcing now is perceived as an industry mainstay and one that prospective companies view as part of the array of strategic options available to secure an organization's viability and growth. As the marketplace for these services expands, so does the competition and stratification of the services provided. In order to remain competitive, vendors are challenged to understand user needs and sensitivities and, in response, hone and package all aspects of the sales and product/service life cycles.

This survey and analysis examines users' evaluations of vendor marketing and pricing strategies and is published as part of INPUT's Outsourcing Program. The thrust of the survey is to develop an understanding of how users view the following:

- The capability of vendor marketing programs to create interest in outsourcing as an option and maintain the prospect's commitment to the vendor offering in the proposal stage.
- Positive and negative aspects of marketing activities and programs, and recommendations for improvement.
- The capability of service pricing to sustain user interest and commitment to buy during the proposal and contract evaluation stage. Pricing structures and incentives are ranked and discussed. Customer satisfaction with pricing after service startup also is reviewed. Recommendations for attractive pricing packages are discussed.

This report provides critical information for sales and marketing professionals and pricing specialists who provide or plan to provide outsourcing services.

This report contains 40 pages, including 23 exhibits.

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Introduction

Information services outsourcing continues to pick up its pace and to encompass additional information systems activities. INPUT's 1994 report, *U. S. Outsourcing Market Analysis, 1994-1999*, discusses this robust market and forecasts growing diversification and investment in this service area. Companies, small and large, are giving consideration to the possibility of contracting out the staffing, operation and management of systems operations, business operations, network management and desktop services ranging from selected portions to the entire company activity. Reasons for users' interest in outsourcing are manifold. However, the most persistent issues that stimulate the strategic decision to outsource relate to cost considerations and technology challenges.

As the number of outsourcing contracts grows, so do the number and capability of vendors who provide these services. The vendor's competitive edge to win outsourcing contracts includes, among other elements, technical resource and capability, track record and reputation. Equally important are the vendor's ability to successfully market capabilities and to effectively price services.

A

Objective and Scope

1. Objective

The objective of this *Pricing and Marketing of Outsourcing Services* report is to identify customer views and perspectives regarding the manner in which outsourcing services are marketed and priced. The focus is to provide analysis of user response to pricing in the process of vendor selection and to understand user attitudes toward pricing composition. Recommendations are made for pricing and incentive strategies for the vendor to win and hold the commitment of the customer.

In addition to pricing, the report examines user attitudes toward marketing of outsourcing during the pre-sale and pre-contract phases. Analysis of these responses reveals aspects of marketing activities that must be strengthened. The report makes recommendations for strengthening vendor marketing strategies and activities.

2. Scope

This study includes outsourcing customers located in Canada and the United States. The participant companies represent a varied spectrum of industries and annual sales with a variety of outsourcing contracts and service activities. Survey respondents are middle to senior-level managers.

B

Survey Population and Characteristics

This report is based upon a survey of companies that have either recently made the decision to outsource or contracted for outsourcing services during the 1993 to 1994 timeframe. The companies surveyed outsourced either one or multiple aspects of their information service activities. The survey was performed during the first quarter of 1995.

Thirty-one North American companies were surveyed. Selection was based on an effort to include a variety of industry sectors and annual sales. The survey focused specifically on the impact that marketing and pricing have on the decision to outsource. The following subsections discuss the industry sectors, respondent reporting relationships, types of outsourcing contracts and budget allocation to outsourcing.

1. Industry Sectors Surveyed

The companies surveyed represent a variety of industry sectors. As shown in Exhibit I-1, the largest sample populations are drawn from the finance, insurance and manufacturing sectors. More than 50% of the companies have revenues in excess of \$1 billion; see Exhibit I-2 for a distribution of companies by sales.

Exhibit I-1

Distribution of Companies by Industry

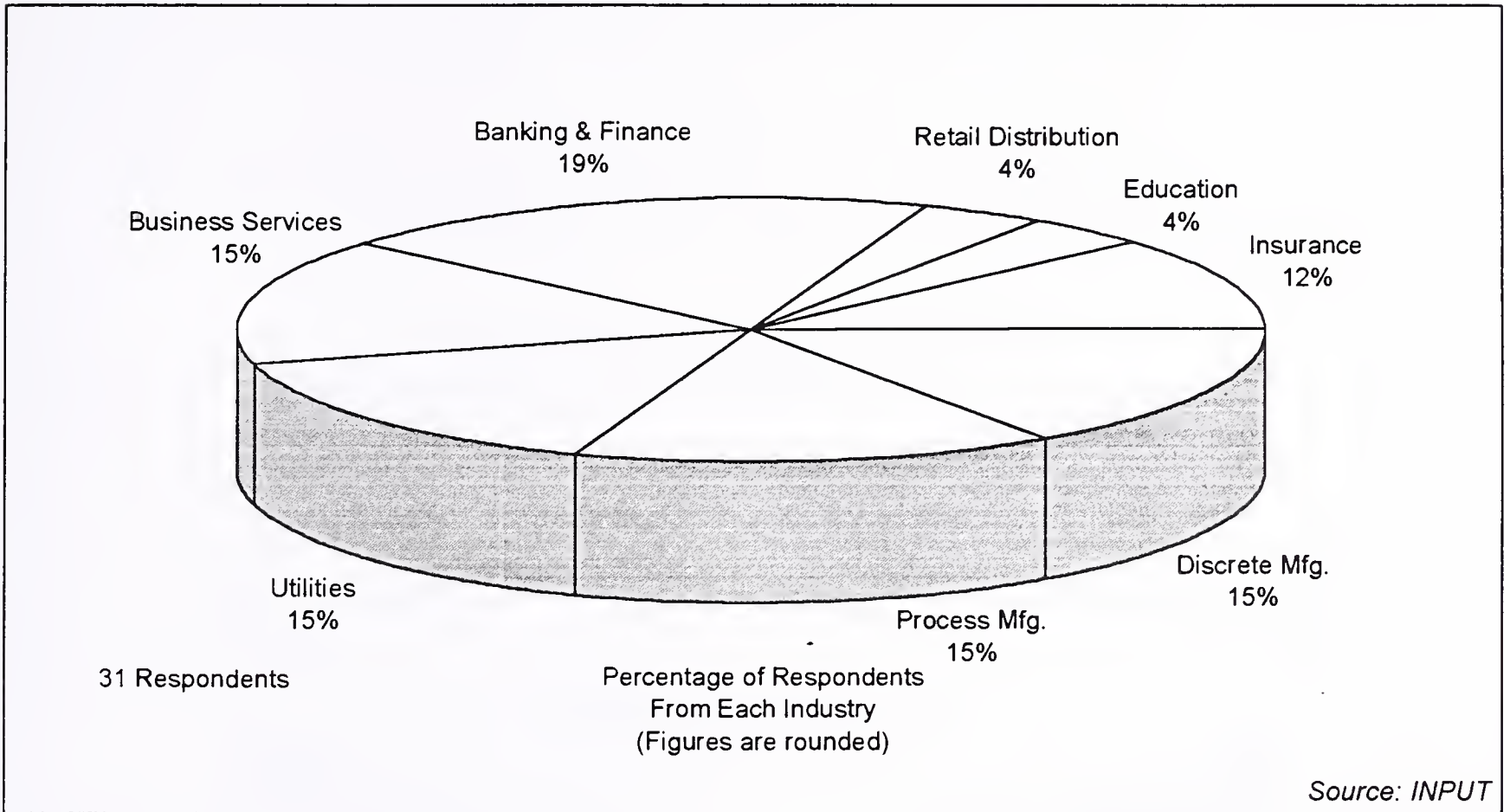
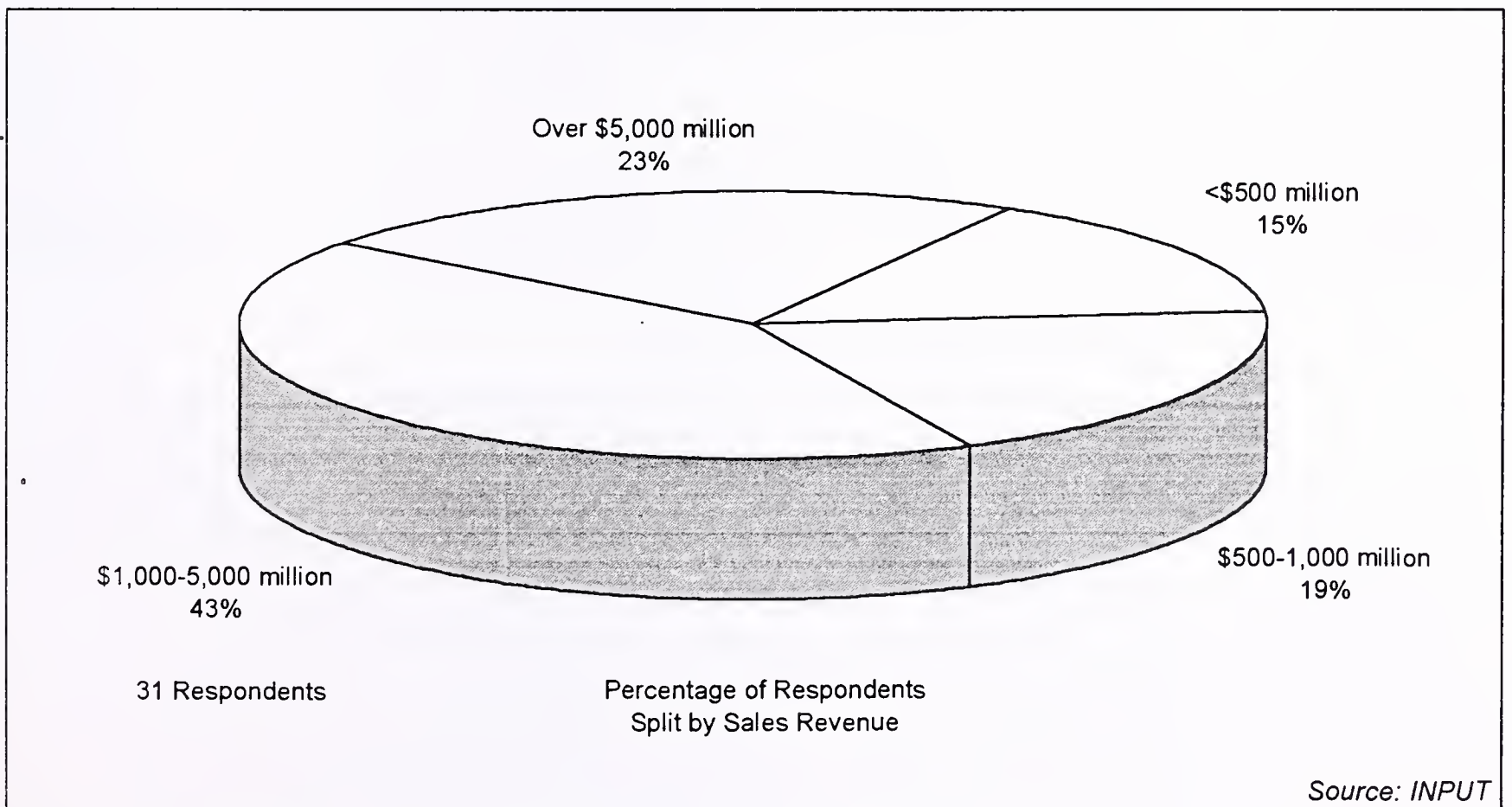


Exhibit I-2

Distribution of Companies by Sales Revenue

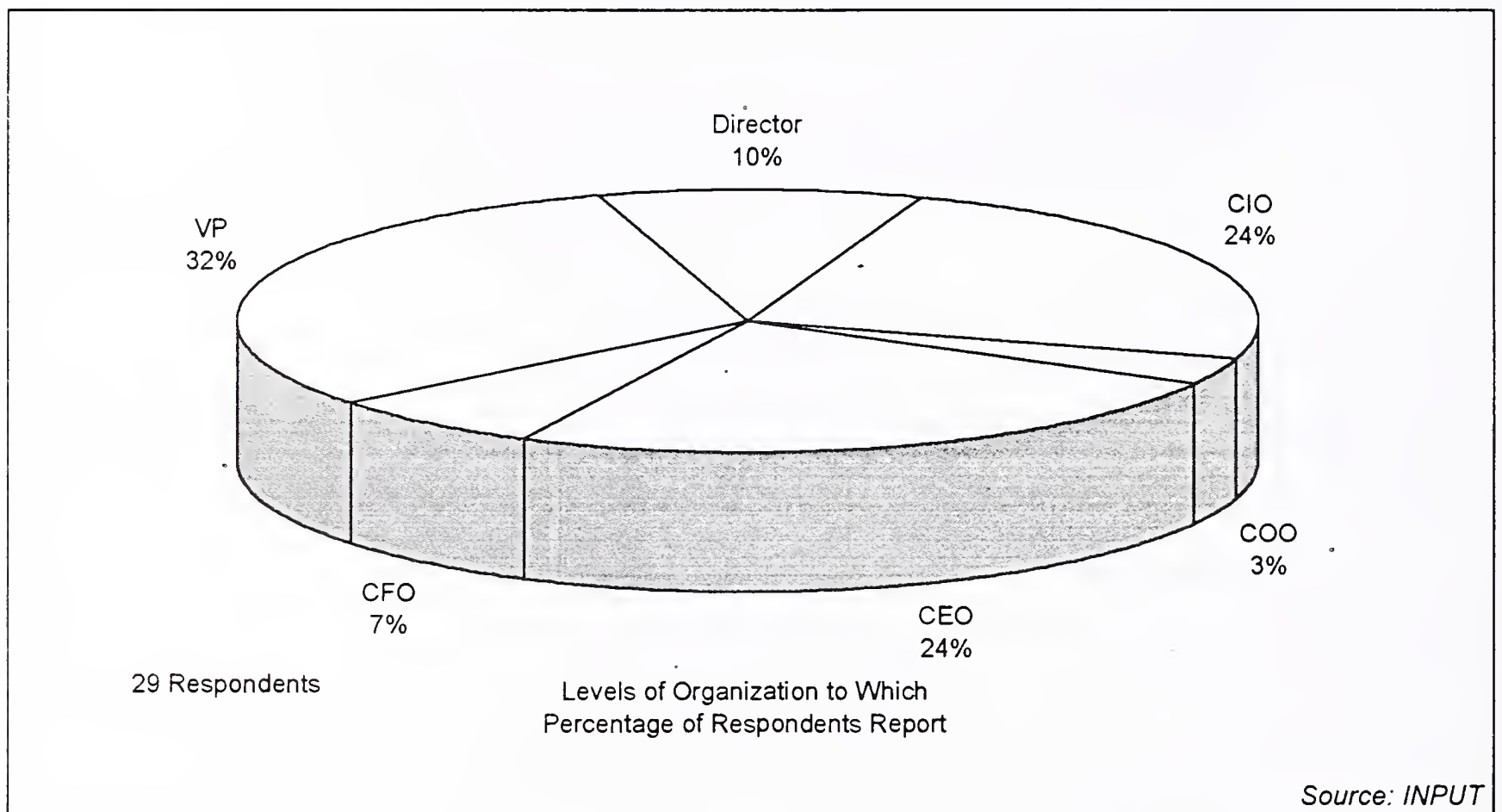


2. Respondent Reporting Relationship

The survey respondents had direct involvement in the organization's outsourcing decision and they reported to senior executives as shown in Exhibit I-3. However, it is important to note that these executives were not necessarily the key influencers in initiating outsourcing activities. Chapter 3, *Major Influencers and Factors Regarding the Outsourcing Decision*, reports on the key influencers in the outsourcing decision.

Exhibit I-3

Respondents' Reporting Relationship

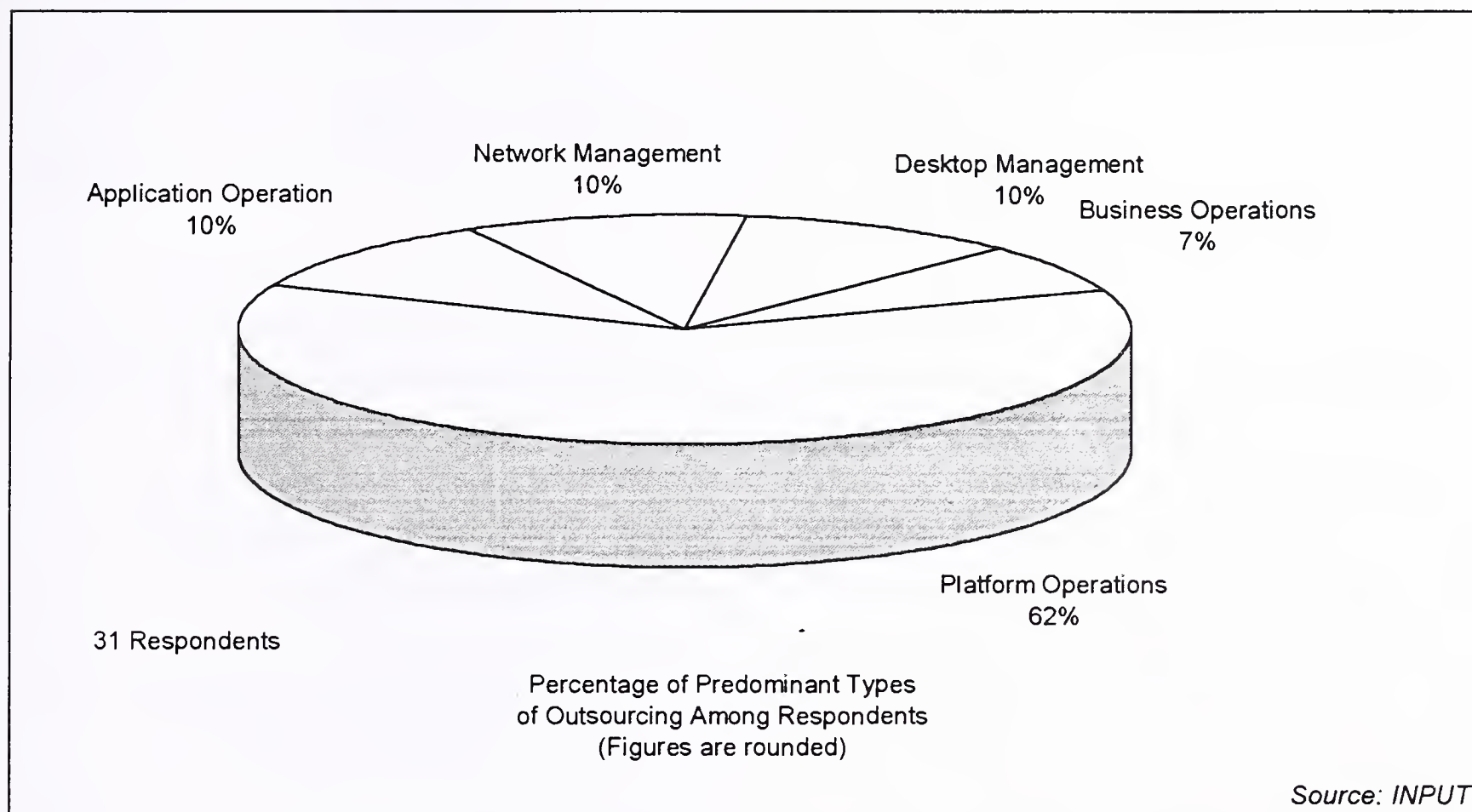


3. Type of Outsourcing Activity

The surveyed companies outsourced a variety of functions or operations. A number outsourced the entire information systems environment, while others were more selective. The distribution of outsourcing activity types is shown in Exhibit I-4. Note that a major portion of the contracts are for the outsourcing of platform operations. This is not surprising in view of the recent trends for companies, small and large, to contract out the operation of the data center or networks of computers. However, it is important to note that a platform operations outsourcing contract may include other support services involving networks, applications and desktop hardware. Therefore, these latter categories may account for a larger portion of expenditure than is depicted in the exhibit.

Exhibit I-4

Outsourcing Contract Types



4. Outsourcing Budget Allocation

For the survey population, the average percentage of information system budget allocated to outsourcing activities is 45%. Individual percentages ranged from 3% to 100%. There is no clear linkage between the outsource activity and the fraction of budget allocated to that contract. However, in most cases, platform outsourcing correlated with the larger percentage budget allocation statistics.

C

Report Organization

The remainder of the report is organized into four chapters:

- Chapter II, *Executive Overview*, provides a synopsis of the study findings, along with recommendations.
- Chapter III, *Major Influencers and Factors Regarding the Outsourcing Decision*, reviews who influences the decision to outsource and what factors are integrated into the evaluation and decision to outsource.
- Chapter IV, *Impact of Marketing on Outsourcing Decision*, discusses marketing's influence during the pre-sale and pre-contract phases. Recommendations are given.
- Chapter V, *Impact of Pricing on Outsourcing Decisions*, discusses customer evaluation processes and preferences for pricing configurations. Recommendations also are provided.

D

Related Reports

For additional insight into outsourcing, readers are encouraged to consult other INPUT reports, such as the following:

U.S. Outsourcing Market Analysis, 1994-1999

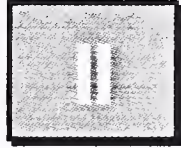
The Impact of Business Process Reengineering on Outsourcing

The Role of the CFO in Outsourcing Decisions

Client Satisfaction with Outsourcing

Business Operations Outsourcing

Desktop Services—User Perspectives



Executive Overview

Outsourcing all, or selective portions, of a company's information systems activities has become a powerful strategic option available to management in pursuit of its organization's success. As outsourcing has earned acceptance, the service options have expanded and vendor competition has become more intense. Vendors cannot afford to ignore any aspect of the marketing and service delivery life cycle. This study focuses on user evaluation of vendor marketing and pricing practices and the impact of each on outsourcing evaluation and subsequent buying decisions.

The vendors' ability to use marketing to stimulate interest in outsourcing evaluation and to manage the prospect's buying decision during the proposal phase are surveyed and assessed. Observations of strengths and weaknesses, along with improvement recommendations, are discussed in this report.

Users view pricing composition as one of the most important aspects of the contract package. The relationship of price and service to the user's perception of value is paramount. Pricing composition is assessed, with emphasis on user ratings of the price structure and user preference for incentives. Recommendations for attractively pricing the service package are discussed.

A

Marketing Impact

The report's marketing study revealed that user rating of vendors' ability to create interest in outsourcing is low and that few users gave credit to vendors for professional and creative efforts. Survey and analysis reveals suggestions for strengthening marketing ability to address an organization's needs and concerns when outsourcing is evaluated as an option.

In addition to creating interest in outsourcing, users rated vendors' marketing ability to win business during the proposal phase. A majority of users gave vendors a rating that is, at best, mediocre. The recurring theme in the majority of responses is that users believe it is important that the vendor possesses the relevant technical resources, understands the user's business needs and is able to help the user address critical success factors. Though this may appear obvious, the low rating attributed to marketing implies that the message of vendor capabilities in these areas is not being conveyed to the user community.

The final aspect of the marketing survey involved user assessment of vendors' general marketing ability. The common theme in this response is that selling benefits, backing up claims of technical competence and willingness to listen to the prospect are indispensable ingredients. In addition to these, the survey details suggestions for improving future marketing activities.

B

Pricing Impact

Pricing of outsourcing services is a critical factor in the evaluation of the contract package. This aspect, along with the level of service, are determinants of the user's value assessment. Nearly half of the respondents ranked price as a primary evaluation factor; others identified additional factors that may take precedence. These include contract flexibility, reliability guarantees, service level and the ability to match the user's environment.

The majority of pricing agreements in the survey population were on a fixed-price basis. Many contracts combined fixed-price components with variable-price contracts. It is interesting to note that a number of respondents would take the opportunity to renegotiate their contract, given the opportunity.

The survey assessed the metrics and evaluation criteria used to rate the proposed pricing structure. In the majority of cases, comparison of internal and external costs drove the decision process. Other evaluation criteria used for pricing assessment are discussed in the report. Most users agreed that there is a trade-off between duration of contract and price.

C**Conclusions**

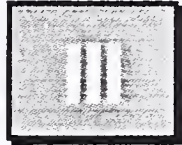
INPUT's assessment is that vendors' general marketing ability to create interest in, and close business for, outsourcing services needs to be improved. Users advised that efforts to strengthen sales and marketing activities require an emphasis on professional solutions selling. Included in the recommendations for improvement are:

- Demonstration of the ability to understand the user's business and technical needs
- Proof that costs can be lowered
- Demonstration of professionalism, openness and creativity

Pricing structure and composition are a primary concern in the evaluation of outsourcing value and vendor selection. Analysis of survey results reveals that:

- Fixed pricing of components or the entire contract coupled with incentives is strongly preferred
- Users are uneasy with the contract terms, after they had an opportunity to experience and evaluate the outsourcing operation over a period of time

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Major Influencers and Factors Regarding the Outsourcing Decision

In order to place in context the impact that marketing and pricing have upon the decision to outsource, it is important to understand who the influencers were and what factors led to the conclusion to seek out and contract for outsourcing services. This analysis will help to set a framework in which the marketing and pricing responses can be better understood.

- Section A, *The Key Influencers*, focuses upon the primary person responsible for initiating the decision to evaluate or adopt outsourcing. In addition, further analysis is devoted to other significant influencers in the decision to evaluate and adopt outsourcing.
- Section B, *Influencing Factors*, examines the factors that were crucial to the outsourcing decision process.

A

The Key Influencers

The study results reveal that, almost without exception, the decision to begin an investigation into outsourcing's advantages and benefits is made at senior operational levels. Exhibit III-1 indicates the management level identified with influencing the outsource decision.

Exhibit III-1

Key Decision Makers

Position or Title	Number of Responses	Percentage of All Responses
CEO and President	5	17
CFO and General Manager	3	11
CIO, VP of IS and VP of Transition Outsourcing	16	54
IS Mgr., Business Analyst and Committee	5	18

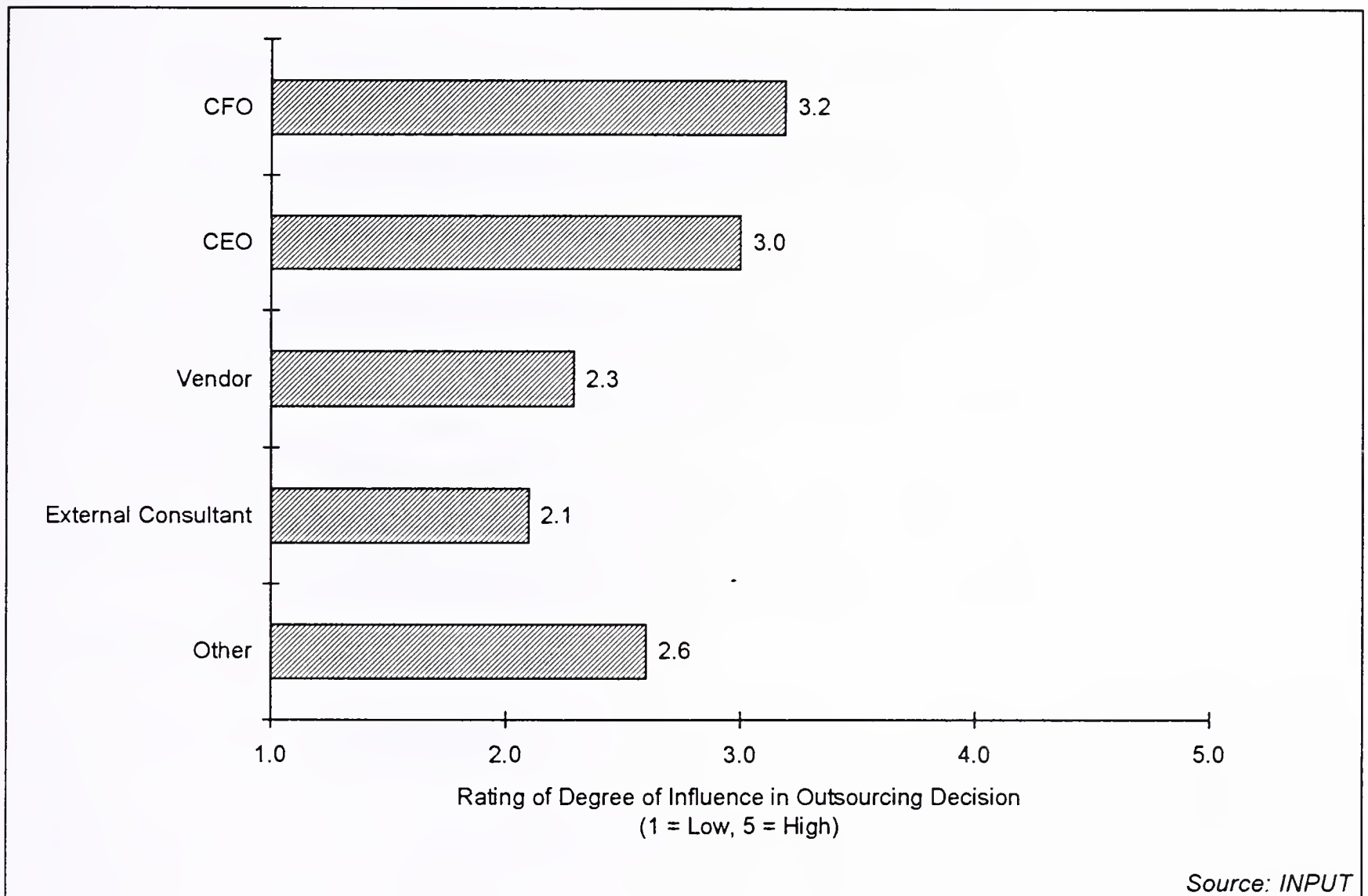
Source: INPUT

The heavy weighting toward senior management is not surprising in view of the fact that outsourcing initiatives are, many times, reactions to the organization's need to realign cost structure or financial condition. Secondary factors driving an organization to consider outsourcing relate to restructuring or technical staff skill shortage. These issues are treated in detail in the next section. The aggregate number of CIOs and VPs of Information Systems and Transitional Outsourcing, accounts for more than half of the responses; this should not be a surprise in light of the technical evaluation required for the decision to outsource. In three cases (10%), a committee was involved in the decision to explore outsourcing.

The study also investigated the degree of influence key members had in evaluating or promoting an outsourcing contract. The ratings of influencing factors are shown in Exhibit III-2; the larger the number, the greater the influence rating (i.e., 5 being the maximum rating).

Exhibit III-2

Decision Makers' Influence



The exhibit highlights the involvement of senior-level management in the outsourcing decision. The next largest rated category is other—legal counsel and senior human resource management were mentioned as being included in this category. The lower rating for the external consultant and vendor categories gives a clear indication that the potential user tends to keep analysis internal and to minimize the involvement of outside consultant assistance. For further discussion regarding the role played by the CFO in the outsource decision, see the 1994 report, *The Role of the CFO in Outsourcing Decisions*.

B

Influencing Factors

There are numerous factors that motivate the user to consider outsourcing. In nearly half of the cases of those surveyed, the primary concern was cost or financial factors. Implicit in this are considerations of the cost of technology upgrade, including investment in hardware, software and personnel skill. Additionally, there is concern regarding the

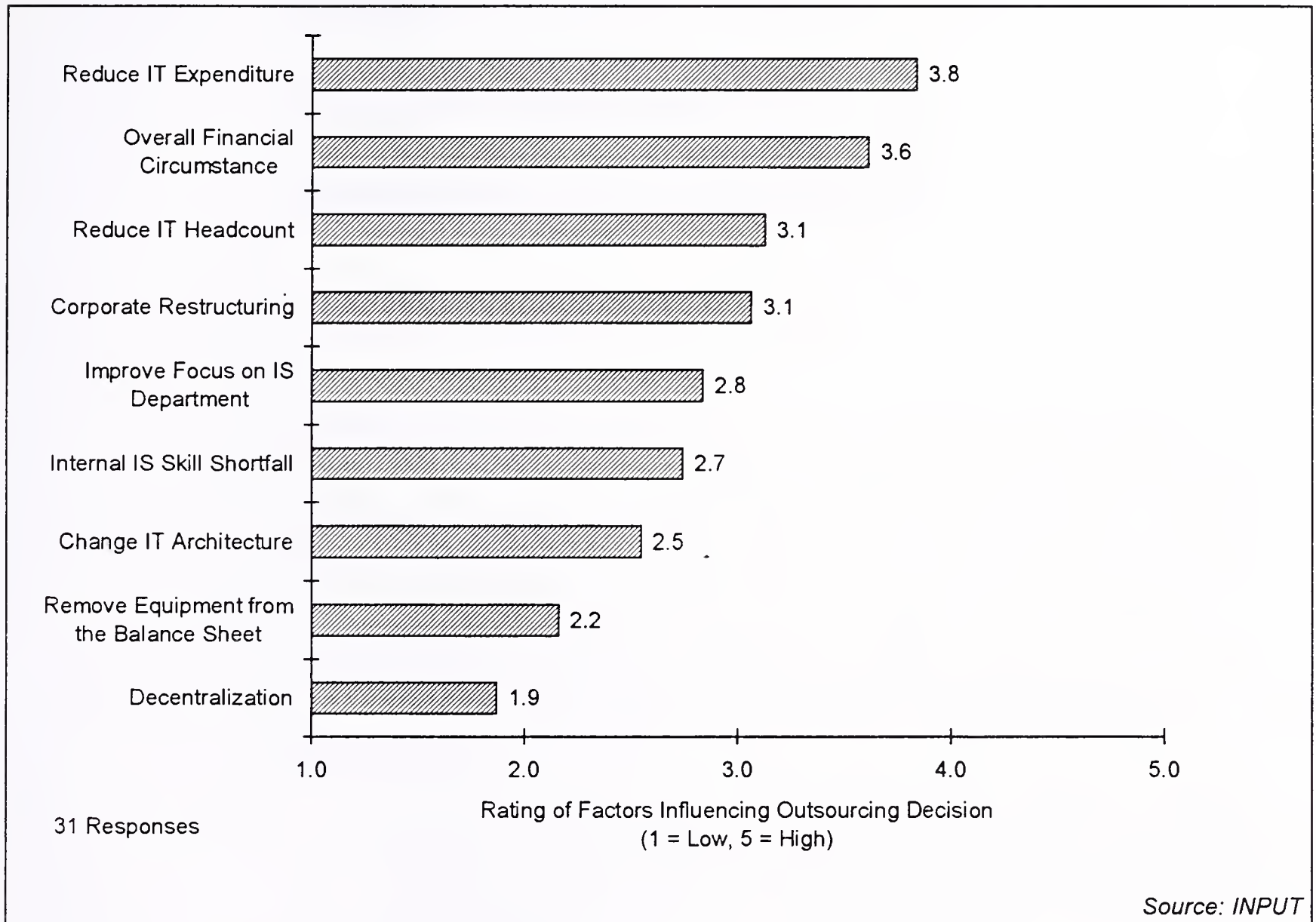
cost of maintaining legacy systems and/or the potential saving in moving the mainframe to the outsourcer's premises and off the balance sheet.

The second-tier drivers are largely tied to issues of technology. Ultimately related to the cost of operation, a primary concern for a number of users was to outsource in order to focus resources on retraining and development of client/server applications. In one case, the company was pleased that the outsourcing company would be able to create a better career path for the technical personnel who would be transferred. In another instance, the company elected to outsource in response to concern about a disaster similar to the World Trade Center bombing. Finally, outsourcing offers a more manageable response to the issues of transition to new technologies while continuing support of legacy systems.

In addition to determination of the major factors, the study assessed the rating, on a scale from 1 to 5, of the importance of these and additional factors. The results are shown in Exhibit III-3.

Exhibit III-3

Rating of Influencing Factors



The ratings confirm the qualitative responses that cost/financial considerations are paramount, while issues of restructuring, headcount and skill shortfall ranked as the next level of concern.

Analysis of these responses provides clear indication of the likelihood that future buying criteria will involve the company's need to shift internal resources from maintenance activities and outmoded technologies to skills upgrade and strategic systems development.

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Impact of Marketing on Outsourcing Decisions

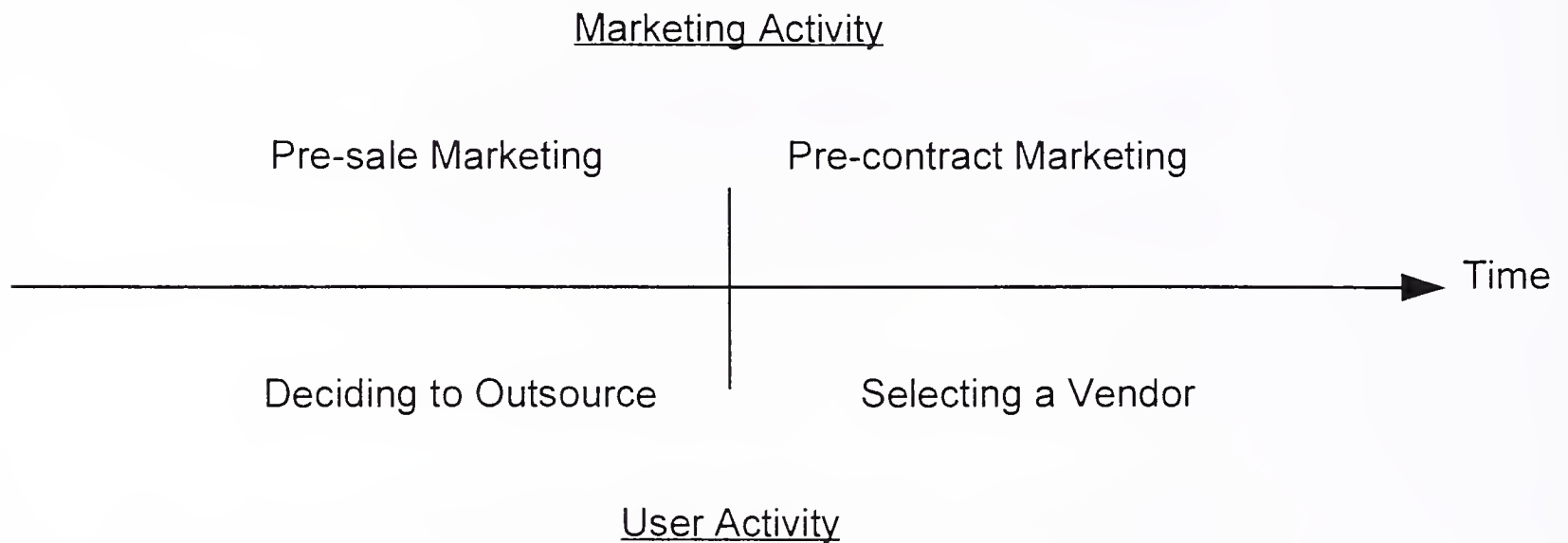
A primary focus of this study is to develop an understanding of the impact that marketing has on the stimulation of interest in outsourcing, and on the evaluation of vendor offerings that may lead to new business. Many of the qualitative responses relate strongly to the leading factors discussed in Chapter III, *Major Influencers and Factors Regarding the Outsourcing Decision*. The results of this survey provide for a better understanding of positively perceived marketing approaches and, at the same time, reveal weaknesses and areas for suggested marketing improvement.

- Section A, *Pre-Sale Marketing Effectiveness*, details user reaction to vendor efforts to initiate interest in outsourcing services. In addition to user rating, qualitative suggestions for improvement are discussed.
- Section B, *Pre-Contract Marketing Effectiveness*, discusses vendor efforts to convince users to select the proposed service. Effective marketing thrusts and suggestions for improvement are reviewed.
- Section C, *Overall Marketing Evaluation*, is devoted to a discussion of users' recommendations for improving the effectiveness of the overall marketing to instigate and win outsourcing contracts.

The difference between pre-sale and pre-contract marketing can be illustrated best when considered in relation to time and the associated user activities.

Exhibit IV-1

Timing of Pre-Sale and Pre-Contract Marketing



Source: INPUT

As shown in Exhibit IV-1, pre-sale marketing occurs at an earlier stage in the sales cycle than pre-contract marketing. This means that there are different objectives and measurements of success for each of these types of marketing.

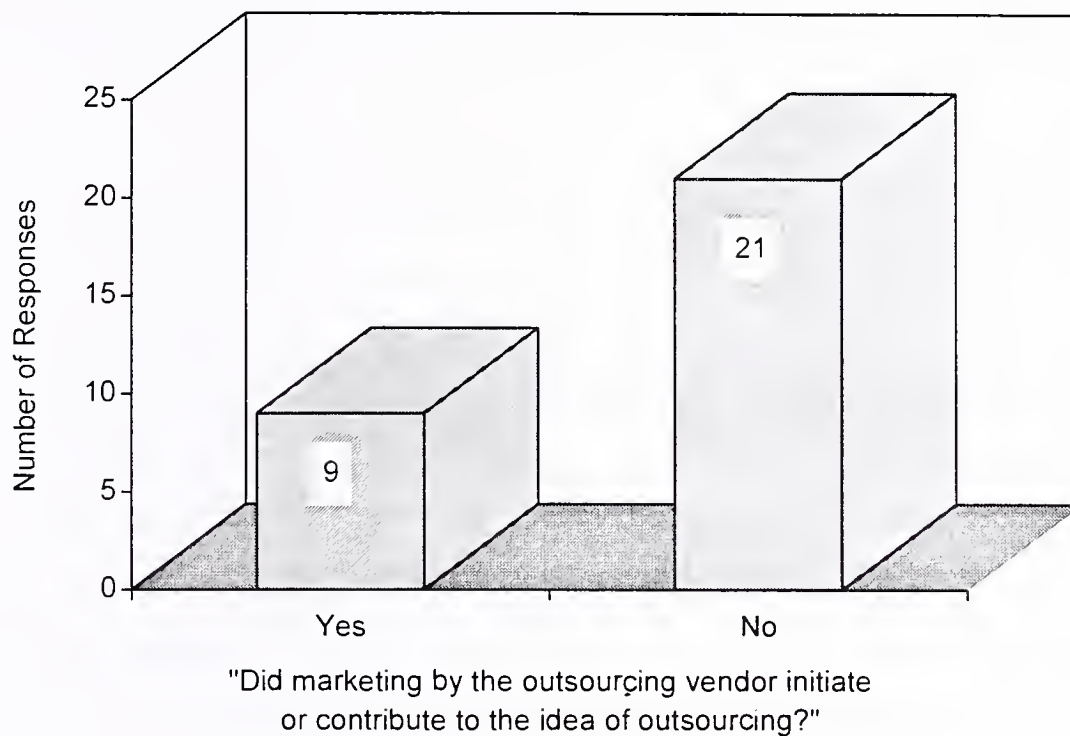
A

Pre-Sale Marketing Effectiveness

Marketing's ability to stimulate user interest in the concept, advantages and benefits of outsourcing is an extremely important issue. As the diversity of outsourcing usage expands, the ability to involve the prospective user in evaluating outsourcing operations will be a significant determinant of vendor market share. Exhibit IV-2 shows the response to the question, "Did marketing by the outsourcing vendor initiate or contribute to the idea of outsourcing?"

Exhibit IV-2

Pre-Sale Marketing Assessment



Source: INPUT

Seventy percent of the respondents reacted negatively—an overwhelmingly negative response. Factors that contribute to such rating are discussed in Section C, *Overall Marketing Evaluation*.

Those users who responded positively were impressed by their vendor's ability to relate to needs and provide clear statements regarding outsourcing benefits. There are several themes judged positively in those marketing efforts. First, selling value and cost saving at the senior management level were mentioned. One company outsourced all information systems activities and was impressed with the vendor's ability to point out service ideas that previously had not been considered. Another company that contracted for full data center outsourcing was impressed by the vendor pointing out how the outsourcing was possible, in addition to showing a real interest in providing the service. Finally, another user with legacy systems reacted positively to the vendor's suggestion that legacy system maintenance required different focus, skills and tools than the user could allocate to the task.

The positive responses indicate that there are avenues for attracting prospective users' attention—most relate to convincing the user that the vendor understands and has the resources to handle the prospect's business and functional needs. The vendor must understand the critical issues that the prospect is dealing with, whether financial, technology-

related or a combination. The senior positioning of the influencers means that marketing must address topics such as: how money can be saved, how the vendor's resource base relates to the prospect's needs and how all of this relates to adding value.

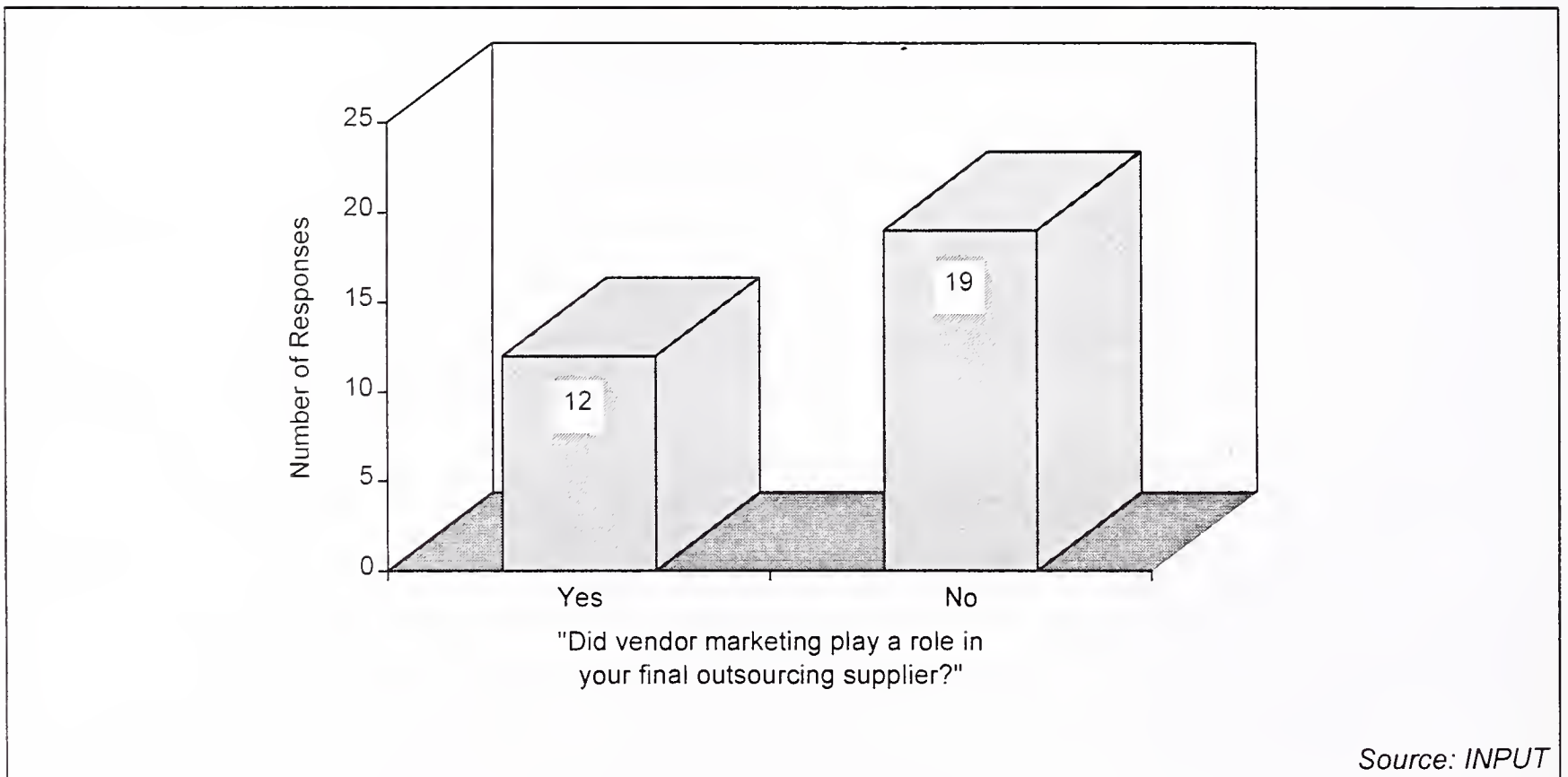
B

Pre-Contract Marketing Effectiveness

The period of selection of and contracting with the outsourcing vendor is the pre-contract phase. Exhibit IV-3 shows the survey response to the question, "Did vendor marketing play a role in your final outsourcing supplier?"

Exhibit IV-3

Pre-Contract Marketing Assessment



The response to this question reveals an improvement in user reaction to the vendor effectiveness, when compared to the pre-sale marketing response. However, it is important to note that more than two-thirds of the responses were negative.

Those giving positive ratings revealed that they were impressed by the vendor's creativity and ability to relate capability to prospective user's needs. Ten of the twelve users responding positively gave additional information regarding their reasons. In four cases, the users selected the vendor who originally suggested outsourcing and followed up throughout

the evaluation process. However, the recurring theme in the majority of the responses was that the company believes it is important that the vendor have relevant technical resources on board, understand the user's business needs and be able to help the user address issues critical to its success.

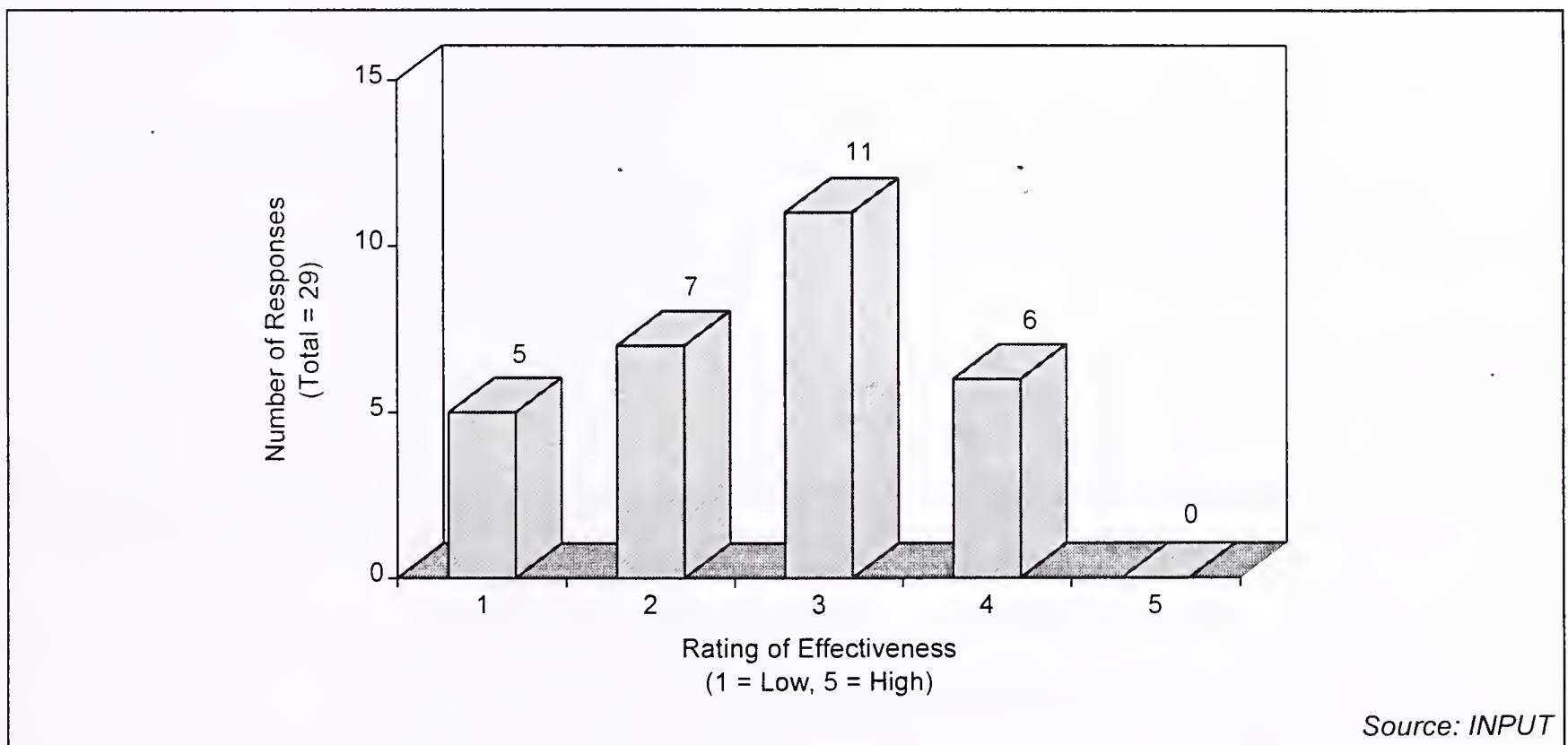
C

Overall Marketing Evaluation

In addition to the assessment of marketing's impact on the pre-sale and pre-contract phases, users were surveyed for rating of general vendor marketing activities. They were asked to rate overall outsourcing marketing on a scale of 1 to 5 (5 being the highest and 1 the lowest); the result is shown in Exhibit IV-4.

Exhibit IV-4

Rating of Marketing Effectiveness



The average rating of 2.6, on a scale of 1 to 5, is mediocre. Only 20% rated the effectiveness at a 4 and none gave a rating of 5. Users' perception of vendors' ability to use marketing to stimulate interest in outsourcing, leading toward a contract, leaves much to be desired.

In addition to the rating, users were asked about positive and negative aspects of vendor marketing activities. Exhibit IV-5 provides a tabulation of these responses.

Exhibit IV-5

Comments About Vendor Marketing Activities

Positive Comments	
Vendor offered employment to all personnel impacted by outsourcing contract	Vendors who are willing to provide outsourcing consultation on a contingency basis
Vendors focused on outsourcing economics	Vendor had knowledgeable personnel
Vendor showed how to save us money	Vendor provided references
Vendor flexibility to do whatever is needed	Vendor idea to transfer responsibility was positive, resulting in less headache and use of resources (i.e., personnel and equipment)
Vendor flexibility in staffing and service level	

Negative Comments	
Vendor attempts to extend outsourcing into areas that are not considered necessary	Vendor attempted to extend service reach into areas not believed to be necessary
Cold-calling vendors who say that they can save money	Vendor set price high and at last minute cut price to win job; then went over our heads to win the job
Vendor misrepresented their service	Vendor service level left a lot to be desired
Vendor misrepresented service capability	Vendor stated to non-IT senior management that often the internal departments learn how to be more efficient by using proposal information
Vendor was unprofessional and failed to explain how outsourcing would achieve our goals	

Source: INPUT

The positive comments provide an underlying message that the vendor possesses powerful and attractive alternatives in the face of customers' problems of limited resource availability and need to control costs. The availability of knowledgeable personnel, ability to absorb customer personnel and flexibility to fill the technical gaps are the primary resource-related issues.

The negative comments highlight issues of incompetence and lack of professionalism in sales and marketing. No prospect warms to the mindless pitch and the over-reaching claims.

As a follow-on to the rating survey, the respondents were asked what type of marketing would entice them to outsource again in the future. "Marketing that addresses the issues of cost or economics" was the response mentioned the most frequently (25% of respondents). Other important considerations mentioned include understanding the user's business, adding value, and using vendor resources to supplement company requirements for leading-edge skills. Exhibit IV-6 summarizes key suggestions for future marketing.

Exhibit IV-6

Key Suggestions for Future Marketing

- Demonstrate how costs can be savings
- Demonstrate involvement in and understanding of the user's business
- Address the phobia of outsourcing
- Propose specific skills
- Show flexibility and willingness to insert incentives into the deal
- Be professional, open and creative

Source: INPUT

D

Conclusions and Recommendations

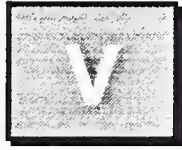
The customer does not give the vendor high grades for marketing acumen. Pre-sale and pre-contract marketing rated poorly. Common themes were that the vendor failed to relate to the prospect's needs. A number of the outsourcing contracts were large (i.e., from \$10 million to more than \$100 million per year), as were some of the vendors. It is surprising that the low marketing effectiveness ratings are unrelated to vendor size. The conclusion is that across the board, vendors must work to improve their marketing strategies and effectiveness in creating interest in and closing on outsourcing business.

The recommendations for improving marketing activities are threefold. First, the ability to demonstrate cost saving specific to the prospect's concerns will enhance vendor positioning, as cost considerations will

continue to be a prime concern. Understanding cost concern and relating marketing directly to that concern will provide the competitive edge. Whether cost control is related to moving hardware and maintenance expenses off the customer's books, managing the expense for retraining customer personnel, improving per-unit cost of operation or any other cost-related concern, the issues must be addressed directly.

Second, marketing should address the customer's potential ability to free up internal personnel resources to be retrained and then to work on leading-edge technologies and strategic services. Vendors must provide evidence that outsourcing can effectively help achieve this goal.

Finally, nothing substitutes for professional marketing personnel who are technically aware and trained to talk intelligently about outsourcing, the benefits of outsourcing and how it is the right solution for the prospect. The professional marketing person must be effective at communicating with all levels of management within the customer organization. Based on the survey response, apparently this is currently a vendor failing. However, the rate at which outsourcing continues to grow clearly justifies vendor investment in sales and marketing of outsourcing services.



Impact of Pricing on Outsourcing Decisions

Chapter III, *Major Influencers and Factors Regarding the Outsourcing Decision*, and Chapter IV, *Impact of Marketing on Outsourcing Decisions*, amply detail customer emphasis on the cost of outsourcing. Ultimately, vendor selection involves pricing considerations. The complex relationship between cost and level of service delivery boils down to perceived value. In addition to the discussion of cost and its impact on outsourcing decisions, value and its importance relative to price are discussed in this chapter.

Pricing structures and incentives in relationship to the nature and length of service also are treated in this chapter. Contract pricing and the user's desire to renegotiate the pricing arrangement is explored.

- Section A, *Value and Outsourcing Price*, is devoted to a discussion of user views regarding pricing and the value of service delivered.
- Section B, *Pricing Composition*, is a review of the pricing methodologies customers selected, their satisfaction with the contract arrangement and desired changes. Further, incentives and the impact of contract duration on price are reviewed.
- Section C, *Evaluation Criteria*, provides the criteria and evaluation basis used for customer selection of pricing mechanisms.
- Section D, *Conclusions and Recommendations*, reviews the trends and makes suggestions for improving pricing attractiveness.

A

Value and Outsourcing Price

The outsourcing contract value is directly related to the contract price for the service, the level of services delivered, and the customer's assessment of cost and value prior to outsourcing. In many instances, these factors are projected into the future. Though in previous sections price is mentioned as a primary criterion for contract award, the customer must assess vendor pricing structures, one against another, the cost avoided by outsourcing (if applicable), and the level of service delivered.

Respondents were asked how they associated value with the business activity or function to be outsourced. The answers varied widely and there was no majority response. There is a diversity of thinking that dictates the need for the vendor to be flexible in its approach to linking pricing and the customer's value assessment.

The most frequently mentioned aspect relative to value was cost and/or price (eight of twenty-eight responses). The next most frequent factor was the customer's ability to focus resources on higher priority issues. These include making it easier to move to client/server projects, move obsolete jobs to the vendor, free up assets to invest in other strategic areas, access skills and procedures that the customer doesn't have, and concentrate on core business activities.

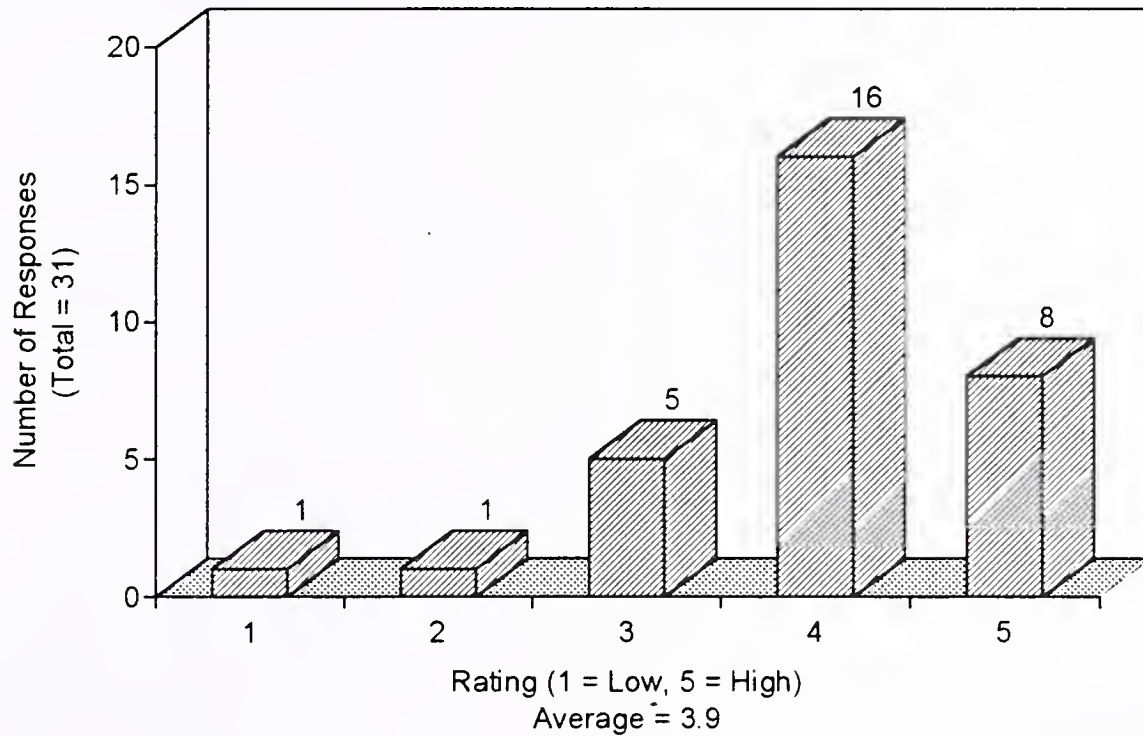
B

Pricing Composition**1. Pricing Importance**

Respondents were asked to rate the importance of pricing composition, on a scale of 1 to 5, a rating of 5 indicating high importance. Exhibit V-1 shows the response frequency for each rating.

Exhibit V-1

Importance of Pricing in Vendor Selection



Source: INPUT

More than 75% of the companies gave pricing a rating of 4 or 5; a strong message, indeed. In addition to the rating, respondents were asked if there were circumstances in which price became less important. Fifteen (48%) said that there are no situations to make pricing a secondary consideration. Those who responded otherwise mentioned a number of factors considered at least as important as price. These other factors are listed in Exhibit V-2.

Exhibit V-2

Alternative Selection Factors

- Ability to add value to the business
- Ability to match current environment
- Flexibility of contract service levels
- Price is less important when the skills are nonstrategic
- High reliability takes precedence over pricing
- If back is against the wall or there is absolute necessity
- Quality of service delivery
- Guarantee of reliability
- Skill and technical capabilities

Source: INPUT

The message is quite clear that, though price is very important, to many organizations there are circumstances in which pricing becomes of secondary consideration. The key trade-off themes are reliability, flexibility, technical competence and service level.

Clearly, the vendor must understand what is driving the prospect to consider outsourcing, in addition to the cost considerations, and cast the marketing approach to satisfy those needs. The trade-off themes mentioned previously are well within the vendor's ability to commit to and deliver upon. It is believed that similar themes, complementary to price, will increase in importance in the future as the customer continues to be challenged by emerging technologies and implementation of new strategic systems. Success in capturing users attention lies in the ability to address these opportunities.

Pricing importance has been noted previously. The majority of the contracts were negotiated on a fixed price basis. Exhibit V-3 shows the distribution of pricing arrangements negotiated.

Exhibit V-3

Pricing Arrangements

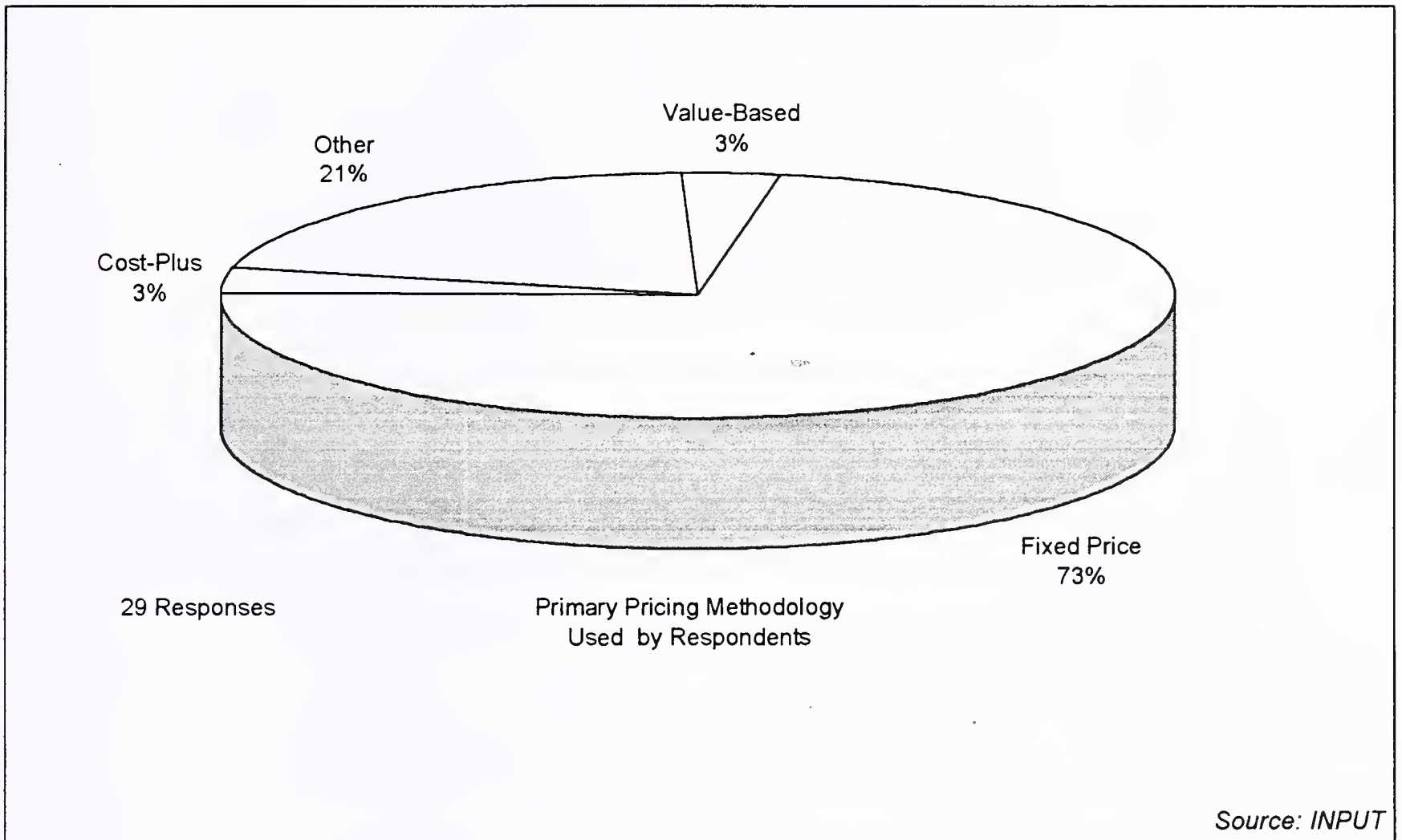
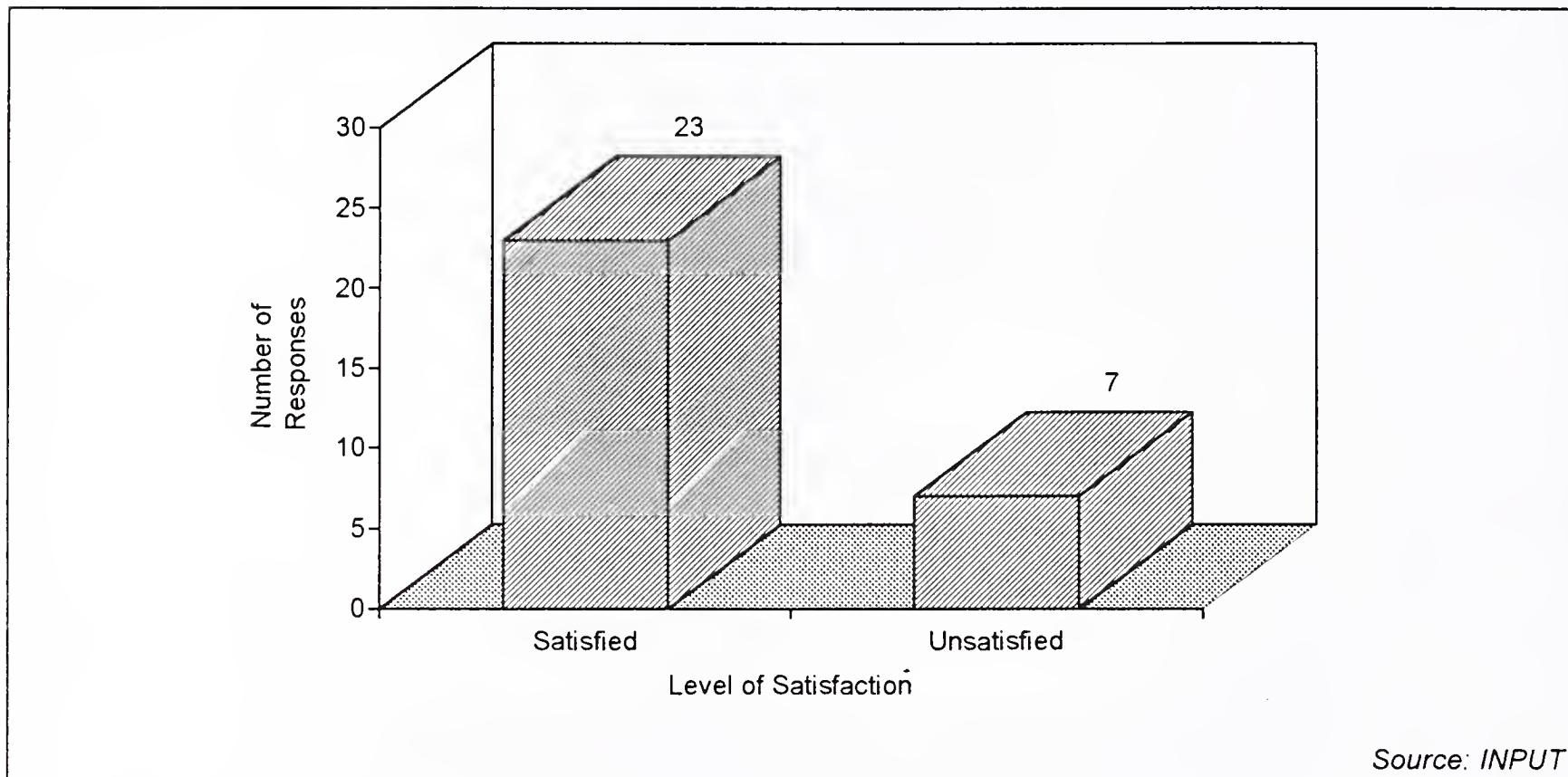
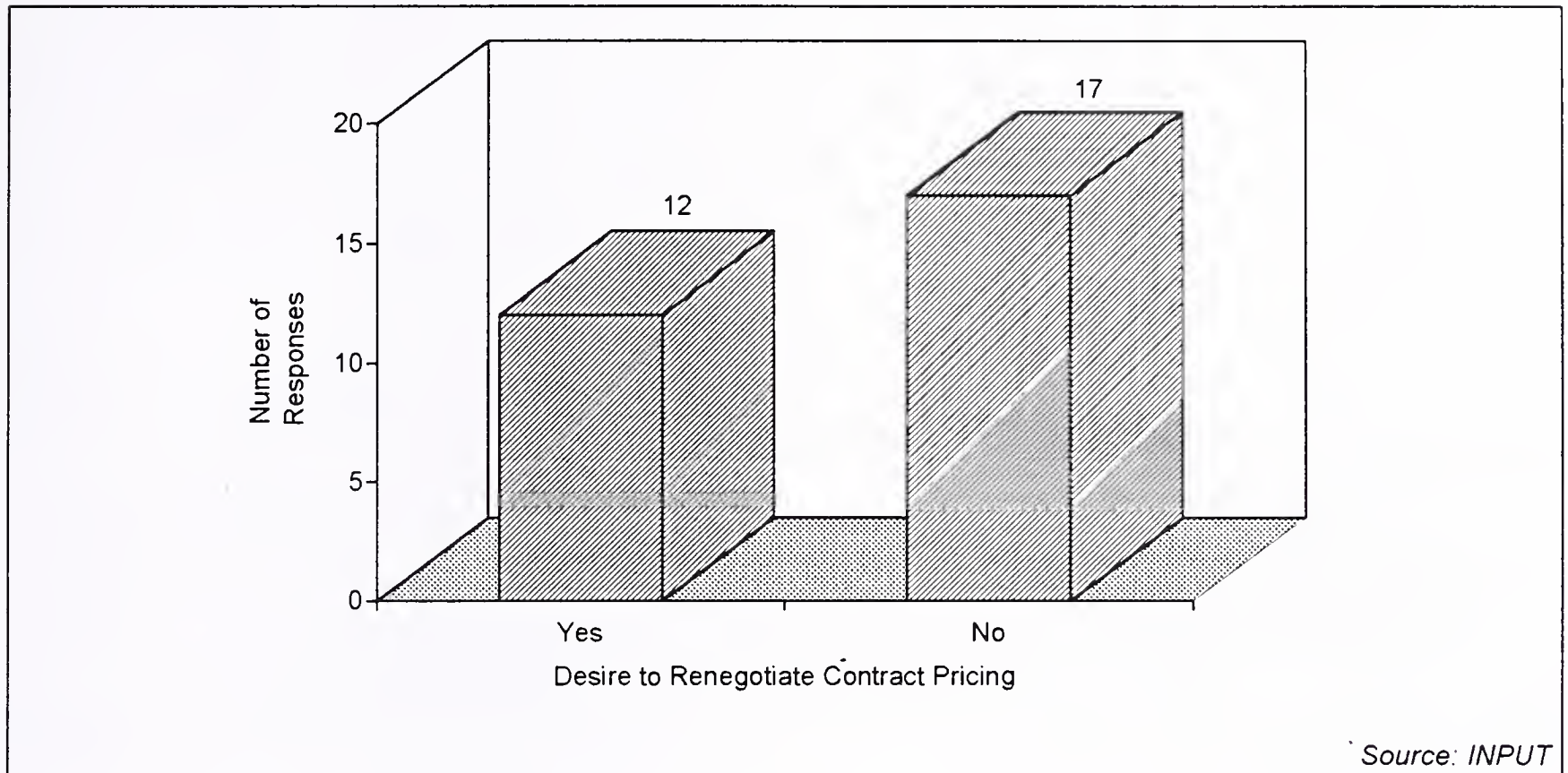


Exhibit V-4

Satisfaction with Contract Pricing

Only seven users indicated dissatisfaction with the negotiated contract pricing (See Exhibit V-4). Further, asked whether they would like to renegotiate, twelve stated an interest in changing selected contract pricing terms (See Exhibit V-5).

Exhibit V-5

Interest in Renegotiating Contract Pricing

In addition to those dissatisfied with the contract pricing, additional companies desire pricing modifications. The latter category would renegotiate pricing terms after having the opportunity to work with the vendor and assessing the cost ramifications involved in the outsourcing operation. This indicates that vendors should ensure that customers have a complete understanding of the pricing terms and give some evidence of the impact that the price structure will have upon customer costs.

Finally, those expressing interest in pricing renegotiation suggested a variety of modifications. Exhibit V-6 gives examples of the original and preferred renegotiated pricing composition.

Exhibit V-6

Renegotiated Pricing Composition

Original Pricing	Renegotiated Pricing
Fixed price	<ul style="list-style-type: none"> - Change overtime calculations - Different rates for on-site and off-site recovery - Build in incentives - Price for backup service
Volume-based fixed price	<ul style="list-style-type: none"> - Reduce price
Fixed-price and cost-plus combination	<ul style="list-style-type: none"> - Not fixed price over a long period of time
Related to level of service	<ul style="list-style-type: none"> - - Change price for the right level of service

Source: INPUT

It is interesting to note that the fixed-price customers show a desire to build in additional granularity to outsourcing service components. The message is that the more the vendor can break down and price the individual service components, the greater the opportunity for customer satisfaction.

2. Components of Pricing

Components of Fixed Price

As discussed previously, fixed-price contracts were preferred by many customers (see Exhibit V-3). Across the entire survey base, twenty-one (72%) respondents had some fixed component in the pricing. Exhibit V-7 provides a list of these structures.

 Exhibit V-7

Fixed Components in the Contract

- Fixed baseline and pay for incremental services
- Leased equipment transferred to vendor
- Fixed price with bandwidth
- Overhead costs
- Baseline fee
- Year-to-year components

Source: INPUT

It is a challenge to agree upon a pricing arrangement that is viewed as a win for the user. For example, one respondent with a baseline contract didn't completely understand what was covered within that baseline and what items would be charged as extras.

Incentives

More than seventy-five percent of the survey respondents thought that incentives should be built into the pricing terms. Many believe that the vendor has little motivation to reduce cost or improve on the efficiency of service delivery if incentives are not built into the contract. Exhibit V-8 lists the incentive considerations mentioned.

 Exhibit V-8

Desired Incentive Items

- Volume-based discount on unit price
- Hardware maintenance done by vendor
- Share in efficiency related to savings
- Expect discounts based on nonperformance
- Warrantees for work and equipment
- Performance penalties
- Incentives on skill levels and service quality

Source: INPUT

Though not asked specifically, the inference drawn from the response to the question about incentives is that a number of users felt a need, after the fact, to insert incentives into future agreements. There is a sense

that vendors may not have built in appropriate incentives for a win-win relationship with the customer. For example, an incentive may be to establish increases in price in exchange for the added risk that the vendor faces for warranties or exceeding baseline service-levels. An alternative is to include penalties on prices for missing service level guarantees or reduction in unit price levels for increased transaction levels.

Contract Duration

The relationship of pricing to contract length was another area that the study surveyed. Nearly 75% of the respondents thought that pricing should reflect the duration of contract commitment. In the majority of cases, users believe that the longer the contract they are willing to commit to, the more the annual price of outsourcing service delivery should be reduced. Vendors have an opportunity to lock in longer term commitments, but only in exchange for price concession.

C

Evaluation Criteria

Price being a primary factor in the decision to outsource, how users evaluate pricing strategies and select a pricing composition was another survey consideration. Forty-five percent (14 users) did benchmark the cost of operation. The majority of the respondents stated that when evaluating the deal, the internal cost was compared to the external cost. Other criteria and methods used for selection are shown in Exhibit V-9.

Exhibit V-9

Pricing Evaluation—Criteria and Methods

- Comparison of internal and external cost
- Ability to achieve financial goals
- Consideration of vendor's limits on the cost
- Comparative evaluation of all vendor quotes
- Competitive comparison using financial model developed by an outside consultant

Source: INPUT

In evaluating the price of the outsourcing contract, there were two primary criteria used (these accounted for 67% of the responses):

- Cost savings that meet a minimum cost reduction level
- Value gained by increasing productivity or efficiency

The remaining 33% reported a variety of approaches, which are summarized in Exhibit V-10.

Exhibit V-10**Alternative Evaluation Criteria**

- | |
|--|
| <ul style="list-style-type: none">• Projected cost over a three-year period• Combination of cost reduction and adding value• Convenience |
|--|

Source: INPUT

The message is consistent. The vendor must price the service and then help the customer assess the cost savings that will be achieved.

D

Conclusions and Recommendations

Contract pricing structure and the prospect of reducing costs is one of the customer's primary concerns when evaluating vendor proposals for outsourcing service. The cost reduction implication can take a number of forms:

- Cost reduction below benchmark level
- Shifting fixed costs to the vendor's books

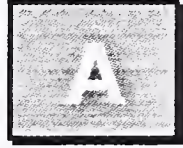
There are trade-off considerations that will drive many customers to assess value delivered. In addition to price, customers are concerned with achieving:

- Improved productivity at little or no increase in cost
- Reallocation of resources (hardware, software and personnel) to free up newer technologies
- Release of personnel to develop client/server-based systems
- Access to vendor's technical resources

It is important for vendors to understand that the criteria for entering into an outsourcing contract have become part of a strategic decision that goes beyond the consideration of mere cost reduction. Although cost remains important, it is linked to the customer's ability to allocate limited in-house resources and stay current with demands of competition and technology. It is reasonable to assume that in the future, cost will diminish in primacy, as resource allocation and access to emerging technology takes on greater importance. Understanding the driving forces and how they relate to evaluation of the cost criterion and its complementary issues is key to winning new business.

Most surveyed customers have contracts that involve either a fixed price contract or contain fixed-price components. The comfort that fixed price offers is not an answer in itself, however. The survey indicates that a number of customers would opt to renegotiate the pricing if the opportunity arose. The uneasiness or lack of satisfaction generally points to the fact that the customer lacks an understanding of the implication of all terms and conditions. Equally revealing is the customer's desire to build incentives into the contract. The fundamental thrust is twofold: linking performance to financial incentives and sharing in the benefit of performance enhancement.

Another suggestion that derives from the survey is that the vendor must instill a sense of "win-win" in the relationship with the customer. Nowhere is this more important than in pricing and its link with service delivery. The customer's belief that value is delivered and that the deal does not disadvantage cost or interests is paramount.



Survey Questionnaire

The following questionnaire was used to gather information for this study.

USER INTERVIEW QUESTIONNAIRE:

PRICING AND MARKETING OF OUTSOURCING SERVICES

This survey is being directed by INPUT, an international research and consulting company. We are conducting a study on how outsourcing vendors should price and market services, as well as the effectiveness of current pricing and marketing approaches. For the following questions, we would like to know as much information as possible about both the chosen vendor and the competition.

The information that you provide will be confidential and neither your name nor your company's name will be connected with any information in the study. In return for your assistance, we will provide you with a summary of our findings at no charge.

To identify who is participating in this survey, could you please list your title or to which organization you report?

Job Title _____

You report to:

CEO: _____	Executive/Managing Committee: _____	
COO: _____	Other: _____	_____
CIO: _____		

1. What percentage of your overall IT budget do you spend on outsourcing?
 _____%

2. Who, within your organization, was the major influence in the decision to evaluate or adopt outsourcing in the contract mentioned above?

Job Title _____

4. How influential was each of the following in promoting the use or evaluation of IT outsourcing in the contract mentioned above? (Please rate on a scale of 1-5 where 1 = no impact and 5 = a major influence)

Chief Executive Officer/Managing Director: _____
 Chief Financial Officer/Financial Director: _____
 Other Director: _____
 External Consultants: _____
 Outsourcing Vendor: _____

5. a.) What factors or circumstances initiated or motivated you to begin thinking about outsourcing this function?

b.) How important were each of the following factors when deciding to outsource? (Please rate on a scale of 1-5 where 1 = not at all important and 5 = extremely important)

Overall financial circumstance: _____
 Desire to reduce IT expenditure: _____
 Desire to reduce IT headcount: _____
 Desire to remove equipment from balance sheet: _____
 Desire to change IT architecture/infrastructure: _____
 Corporate restructuring or downsizing: _____
 Decentralization/creation of autonomous business units: _____
 Desire to improve focus on IT department: _____
 Internal IT skill or resource shortfalls: _____

6. a.) Did marketing by the outsourcing vendor initiate or contribute to the idea of outsourcing? If so, how? _____

b.) Did vendor marketing play a role in your final choice of outsourcing supplier? If so, how?

7. a.) How would you rate the current marketing of outsourcing services? (1 = non existent, 5 = extremely effective): _____

b.) Have you experienced any marketing approaches that impressed you, positively or negatively, in the outsourcing arena? If so, what?

Positively: _____

Negatively: _____

c.) What type of marketing approach would entice you to outsource again in the future?

8. How did you associate a value to outsourcing?

9. Please rank the following in order of importance. (1 = most important, 2 = next most important, 7 = least important)

- Existing relationship with vendor: _____
- Vendor's reputation in marketplace: _____
- Appropriate size of vendor: _____
- Professionalism of sales team: _____
- Contract pricing mechanism: _____
- Flexibility of contract: _____
- Contract price over life of contract: _____

10. a.) How would you rate the importance of price composition in the selection of a vendor?
(1 = not important and 5 = extremely important): _____

b.) Are there any circumstances under which price becomes less important?

11. a.) Were you satisfied with the pricing of your contract? Yes: _____ No: _____

b.) What pricing methodology was used for your contract:

Fixed-price: _____

Cost-plus: _____

Value-based: _____

(the vendor receives a proportion of
the increased revenue or cost savings)

Other: _____

c.) If you had the opportunity to renegotiate the contract today, are there aspects of the
price composition that you would change? Yes: _____ No: _____

Please explain: _____

12. Is your preferred method of pricing dependent upon the type of outsourcing being
considered? Yes: _____ No: _____

Please explain: _____

13.

a.) Did you have a benchmark of how much outsourcing should cost before talking
with a vendor? Yes: _____ No: _____

b.) What metrics did you use in evaluating the deal?
(i.e., internal savings vs. external cost)

14. When evaluating the price of the outsourcing contract, did you decide:

a.) strictly on a "less than current" basis; for example, your current budget is for \$100M, the outsourcing deal needs to be 10% less. Yes: _____ No: _____

b.) or based on the value the vendor is providing to your business, whether it is increasing efficiency, productivity or something else; for example, your productivity increases 10%, decreasing your cost by x%. Yes: _____ No: _____

c.) Other: _____ Yes: _____ No: _____

15. a.) Are there any fixed components in the price of the deal? Yes: _____ No: _____

Please explain: _____

b.) Do you expect incentives to be built into the price (i.e., discounts, warranties)?

Yes: _____ No: _____ Please explain: _____

16. Is the pricing and marketing of outsourcing dependent on the length of the contract?

Yes: _____ No: _____ Please explain: _____

17. Further comments or suggestions:

