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STRATEGIC MARKET PERSPECTIVE

Pricing Mechanisms in Information Systems Outsourcing Europe 1995

Outsourcing Programme–Europe

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Pricing Mechanisms in Information Systems Outsourcing – Europe 1995

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Frankfurt
Perchstätten 16
D-35428 Langgöns
Germany
Tel. +49 (0) 6403 911420
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London
Cornwall House
55-77 High Street
Slough, Berkshire
SL1 1DZ
Tel: 44 (0) 1753 530444
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New York
400 Frank W. Burr Blvd.
Teaneck, NJ 07666
U.S.A.
Tel. 1 (201) 801-0050
Fax 1 (201) 801-0441

Paris
24, avenue du Recteur
Poincaré
75016 Paris
France
Tel. +33 (1) 46 47 65 65
Fax +33 (1) 46 47 69 50

San Francisco
1881 Landings Drive
Mountain View
CA 94043-0848
U.S.A.
Tel. 1 (415) 961-3300
Fax 1 (415) 961-3966

Tokyo
Saida Building, 4-6,
Kanda Sakuma-cho
Chiyoda-ku, Tokyo 101
Japan
Tel. +81 3 3864-0531
Fax +81 3 3864-4114

Washington, D.C.
1921 Gallows Road
Suite 250
Vienna, VA 22182 3900
U.S.A.
Tel. 1 (703) 847-6870
Fax 1 (703) 847-6872

Abstract

Historically the level of satisfaction with IT outsourcing service in Europe has been very high. However, one of the areas of greatest potential conflict between clients and vendors is contract pricing.

Dissatisfaction with contract pricing can be expressed either directly in the form of perceived low value-for-money or indirectly as a result of the contract pricing's impact on the style of service delivery.

The purpose of this report is to analyse client attitudes towards IT outsourcing pricing mechanisms and to identify any differences in attitude towards pricing between clients and vendors.

The report provides:

- A breakdown of the profile of pricing mechanisms used within outsourcing contracts
- An analysis of the perceived advantages and disadvantages of each of a range of outsourcing pricing mechanisms
- Details of user attitudes towards pricing modification, vendor incentives and penalty clauses
- Identification of the profile of pricing mechanisms favoured by vendors.

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Introduction

A
Scope and Objectives

Typically the level of satisfaction with IT outsourcing has been very high. However, one of the areas of potential conflict between client and vendor is service pricing. Vendors wish to implement pricing mechanisms that guarantee higher levels of profitability than simple commodity pricing built around resource-based calculations. On the other hand, clients want a service that has the flexibility to adapt to the changing nature of their business at a fixed and competitive price.

The objectives of this report are to identify:

- The principal pricing mechanisms used within outsourcing contracts
- The perceived advantages and disadvantages of each of a range of pricing mechanisms
- The ways in which users would like to modify the pricing mechanisms currently in use
- User attitudes towards vendor incentives and penalties
- The types of pricing mechanism favoured by vendors.

Outsourcing is defined by INPUT as follows:

Outsourcing is a long-term relationship (greater than one year) between a client and vendor in which the client delegates all, or a major portion, of an operation or function to the vendor. The operation or function may be solely Information Systems Outsourcing-based, or merely include Information Systems Outsourcing as a prominent component of the operation (at least 30% of the budget).

The critical components defining an outsourcing service are:

- Delegating an identifiable area of the operation to a vendor
- Single vendor responsibility for performing that delegated function
- Intended, long-term relationship between the client and vendor
- Contract term is at least one year
- Client's intent is not to perform this function with internal resources
- The contract may include non-Information Systems Outsourcing activities, but Information Systems Outsourcing must be an integral part of the contract
- Outsourcing is a collection of services integrated under a single, long-term contract with one vendor responsible for its operation and management.

Business Operations Outsourcing (also known as, Business Outsourcing or Functional Outsourcing) is a relationship in which one vendor is responsible for performing an entire business/operations function including the Information Systems Outsourcing that support it. The Information Systems Outsourcing content of such a contract must be at least 30% of the total annual expenditure in order for INPUT to include it in the Business Operations Outsourcing market.

Information Systems (IS) Outsourcing can be viewed as a component of the Business Operations Outsourcing market (i.e. Information Systems Outsourcing is a business/operations function, see Exhibit I-1). However, in order to delineate between outsourcing contracts that are solely IS versus those that include IS as well as other functions, IS Outsourcing will be segregated from Business Operations Outsourcing. Information systems Outsourcing is divided into four service components as shown in Exhibit I-2.

- *Systems Operations* outsourcing describes a relationship in which a vendor is responsible for managing and operating a client's "computer system"/data centre (*Platform Systems Operations*) or developing and/or maintaining a client's application as well as performing Platform Operations for those applications (Applications Systems Operations)

- *Desktop Services* is a relationship in which a vendor assumes responsibility for the deployment, maintenance and connectivity of personal computer, workstations, client/server and LAN systems in the client organisation. To be considered as Desktop Services outsourcing, a contract must include a significant number of the individual services listed below:

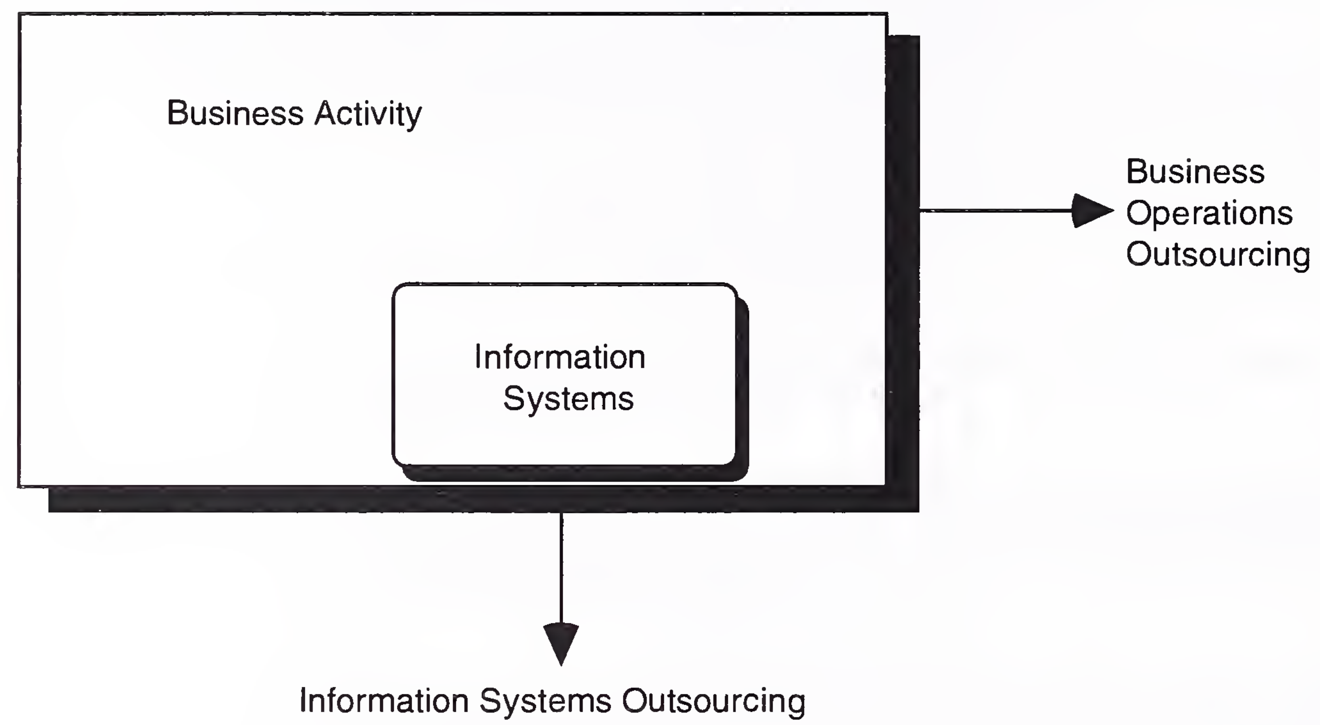
  - Software Product Supply
  - Equipment Supply
  - Equipment/Software Installation
  - Equipment Maintenance
  - LAN Installation and Expansion
  - LAN Management
  - Network Interface Management
  - Client/Server Support
  - Logistics Management
  - User Support
  - Help Desk Functions
  - User Training and Education.

- *Network Management* outsourcing is a relationship in which a vendor assumes full responsibility for operating and managing the client's data telecommunications systems. This may also include the voice, image and video telecommunications components

- *Application Management* is a relationship in which the vendor has full responsibility for developing and maintaining all of the application or function.

Exhibit I-1

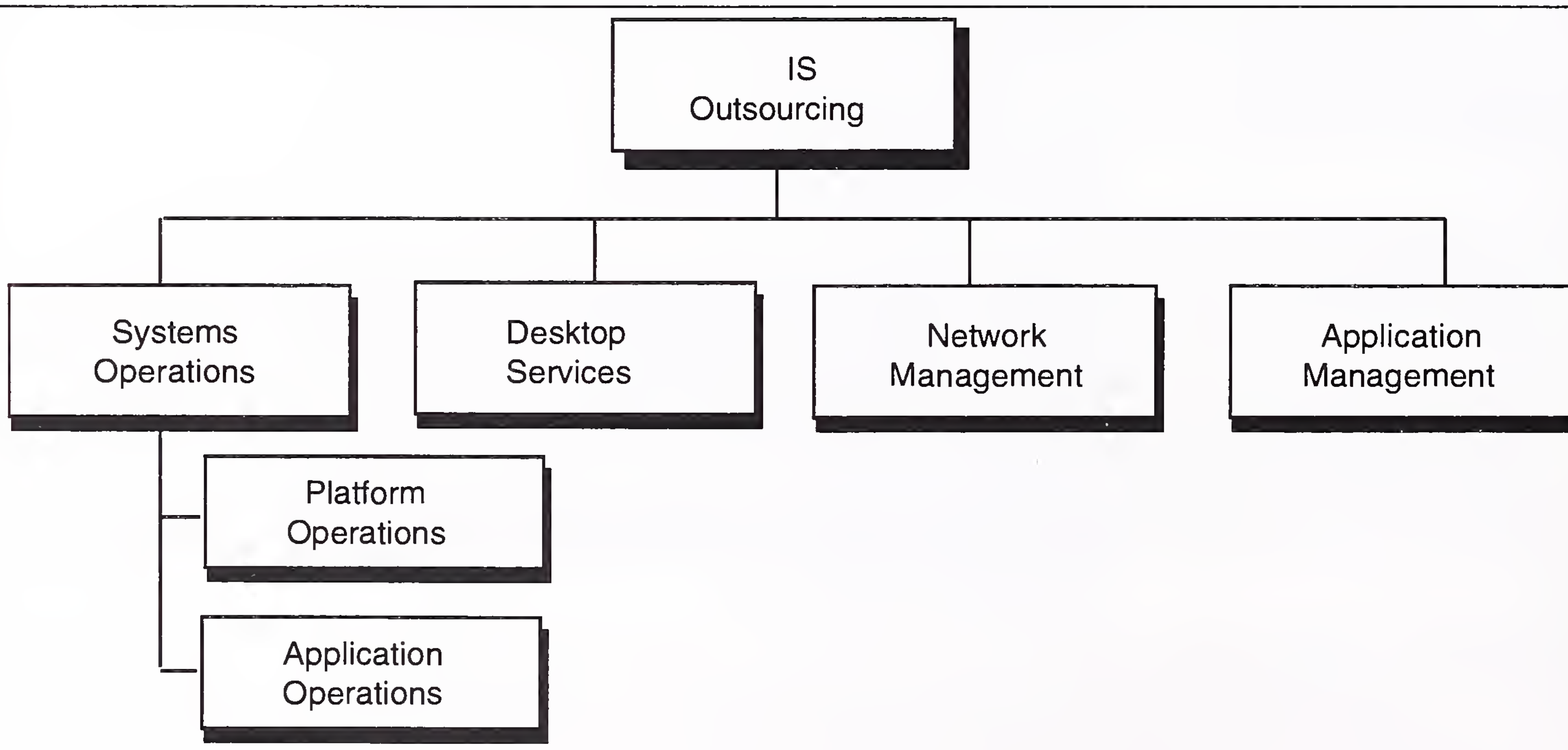
Business Operations Outsourcing



Source: INPUT

Exhibit I-2

Information Systems (IS) Outsourcing Service Categories



Source: INPUT

The above definitions focus on the services covered in the outsourcing contract. For example, an Application Operations contract can include all facets of Information Systems Outsourcing (platform operations, desktop services, network and application management). The key to INPUT's market definition is the service contract . If a customer only wants to outsource the network, it is Network Management outsourcing. If an airline, for example, wishes to outsource their reservation operation which includes not only the network, but also its infrastructure, applications and the people running the operation, this is a Business Operations Outsourcing contract. Exhibit I-3 shows the service components that may be included in each outsourcing service category.

Exhibit I-3

Outsourcing Service Components

Component	Platform Ops	Appl. Ops.	Desktop Services	Network Mgt.	Appl. Mgt.	Business Ops.
Project/Contract Management	X	X	X	X	X	X
Data Centre Management	X	X				X
Client\Server Operations	X	X	X			X
Equipment Maintenance	X	X	X			X
System Software Maintenance	X	X	X	X		X
Application Software Maintenance		X	X		X	X
Application Development		X			X	X
LAN Management		X	X	X		X
WAN/MAN Management		X		X		X
Transaction Processing Services		X				X
Other Professional Services		X	X		X	X
Business Process Operations						X

Source: INPUT

The largest, most visible contracts awarded over the past year have been typically Application Operation outsourcing contracts since they, at least, include management of the infrastructure (datacentres and various computing platforms) and the support of some of the legacy applications. In the past, most Application and Platform Operation outsourcing contracts included Network Management but recent contracts have also included Desktop Services.

What is not included in INPUT's world of outsourcing are the following:

- Project based services are not considered as part of outsourcing. Thus, Systems Integration and application development projects are not included

- Services that were never intended to be performed internally. Maintenance only services do not constitute an outsourcing function by itself. However, responsibility for hardware and software maintenance is inherent in most outsourcing contracts

- Processing services contracts of less than one year

- Voice-only network management

- Business operations with minimal information systems content. The outsourcing of the marketing communication function to an outside agency is not covered by INPUT's analysis. A function or business operation must at least have 30% of its budget attributed to information technology to be included.

B
Methodology

The data in this study was derived from the following combination of sources:

- Five face-to-face interviews with existing clients of outsourcing vendors

- A further 31 telephone interviews with existing clients of outsourcing vendors

- Ten interviews with outsourcing vendors.

The user interviews were spread across organisations in France, Germany and the U.K.

The breakdown of user telephone interviews by country is shown in Exhibit I-4.

Exhibit I-4

Interview Profile by Country

Country	Number of interviews
France	5
Germany	6
United Kingdom	20
Total (Europe)	31

Source: INPUT

All interviews were carried out with organisations with annual revenues in excess of $100 million.

C
Report Structure

Chapter II consists of the Executive Overview which is a summary of the key findings of the report.

Chapter III analyses user attitudes towards the pricing of outsourcing services. In particular, it identifies:

- The relative usage of a range of pricing mechanisms
- The level of satisfaction with contract pricing
- Clients' likes and dislikes
- Client attitudes towards vendor incentives and penalties
- The ways in which clients would like to modify the pricing mechanisms within their current outsourcing contracts.

Chapter IV analyses vendor attitudes and approaches towards the pricing of outsourcing services.

D
Related Reports

Outsourcing Opportunities in Government — Europe, 1993-1998

Client Satisfaction with IT Outsourcing Services — Europe, 1993

Business Operations Outsourcing — Europe, 1993

Desktop Services Outsourcing — Europe, 1994

Impact of Business Reengineering on Outsourcing — Europe, 1994

Identifying & Winning Outsourcing Opportunities — Europe, 1994

Network Outsourcing — Europe, 1995

Information Systems Outsourcing Market — Europe, 1995-2000

Outsourcing In Europe — Competitive Analysis, 1995

II

Executive Overview

A
Pricing Mechanisms Play A Major Role In Successful Outsourcing Service Delivery

Pricing is often seen as an administrative chore by both clients and vendors, and certainly some outsourcing clients are irritated by the amount of negotiation that takes place when they initially award an outsourcing contract.

In addition, both clients and vendors tend to view pricing mechanisms as a means of limiting their exposure to the miscalculations or lack of foresight of the other party. Pricing probably remains one of the areas of greatest mistrust between client and vendor.

There are considerable dangers in these approaches, including the apparent paradox that the outsourcing client can be highly satisfied with the contract pricing yet dissatisfied with the natural consequences of the pricing approach adopted. For example a client can insist on a competitively priced fixed price contract against agreed service levels, be very satisfied with the resulting cost structure, and still complain that the vendor has not invested in the development of a new infrastructure. However, the client will tend to perceive the problem as one of vendor service culture rather than one of service pricing.

The principal objectives for outsourcing must be to improve the effectiveness and efficiency of key elements of the value chain. The objective of increasing the efficiency of support functions such as IT services must be a secondary consideration and not detract from these principal objectives.

Accordingly vendor remuneration needs to be tied to, or at least be consistent with, these primary objectives. There have been a number of instances where the desire to reduce IT costs by outsourcing has had a negative impact on the wider business goal.

Consequently the choice of pricing mechanism can play a very major role in the client's perception of the success or failure of the contract. Indeed the choice of an inappropriate pricing mechanism can lead both to increased price pressure on the vendor and potential loss of the contract on renewal.

To avoid these circumstances, vendors need to demonstrate a greater understanding of pricing from the client's perspective. In particular, it is important to understand that:

- Clients remain concerned about the lack of ongoing cost reduction
- New service types necessitate changes in pricing mechanism
- Clients and vendors have differing attitudes towards incentives and penalty payments
- Clients want innovation and low prices
- Clients need to retain the pricing flexibility to change their outsourcing portfolio.

B
Clients Require Greater Certainty of Cost Reduction

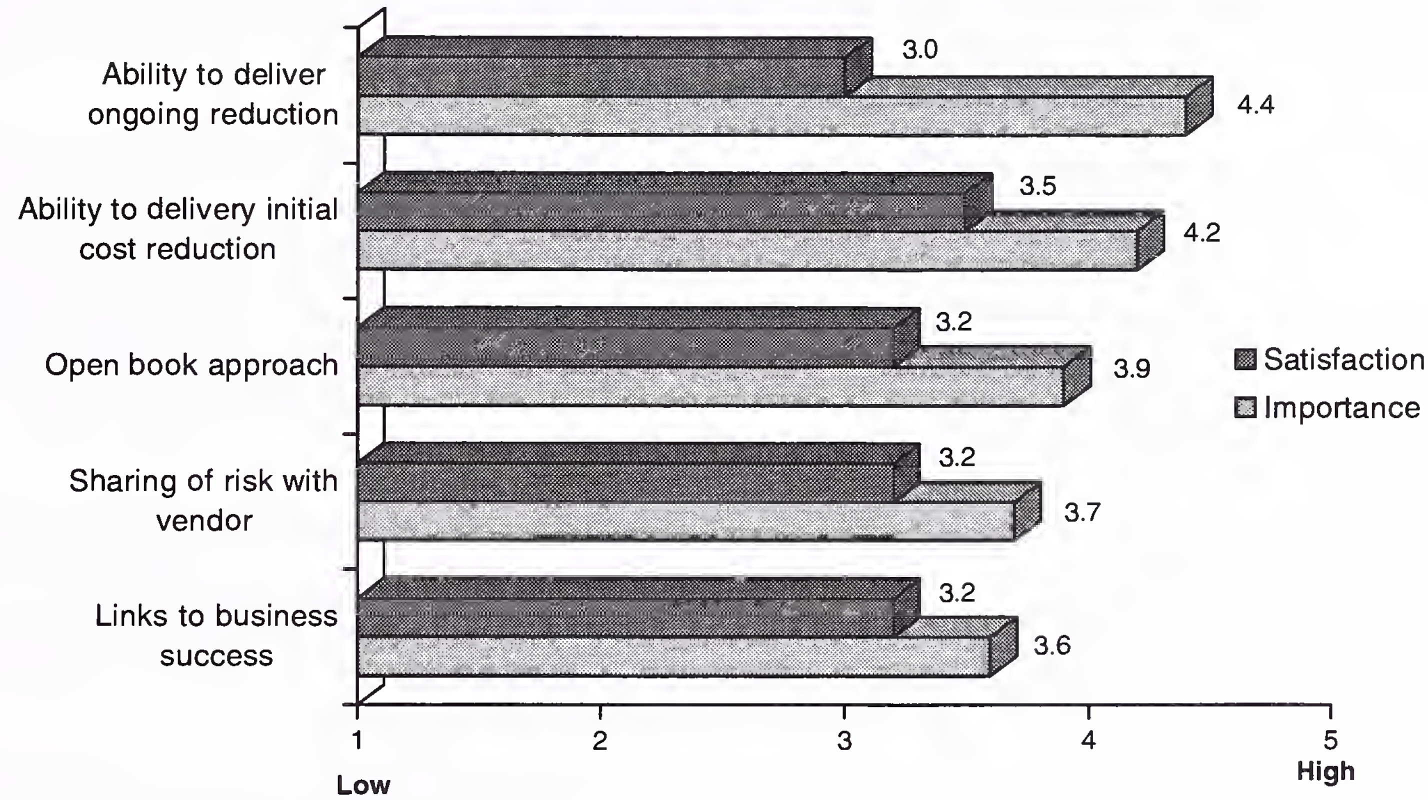
Many of the outsourcing contracts currently in force are dominated by datacentre operation services and the predominant form of pricing mechanism is fixed price. Clients are typically very satisfied with this pricing mechanism because it gives them the major benefit of certainty of budgeting.

However they are much less satisfied with other aspects of their outsourcing contract and service delivery, which typically they do not perceive to have a strong connection with the pricing mechanism used. In particular, two of the most common complaints are a lack of innovation by the vendor and a lack of service flexibility.

Exhibit II-1 lists some additional pricing attributes where there is a significant gap between importance to the client and their satisfaction.

Exhibit II-1

User Satisfaction with Pricing Attributes: Outsourcing Contracts



Sample of 30 respondents. Standard error = 0.2 *Source: INPUT*

As might be expected, vendors are failing to meet user expectations regarding cost reduction. While there remains some scope for improvement in satisfaction with the level of initial cost reduction at contract start-up, this is not the major issue. The major problem is clients' perception that the initial cost reduction momentum is not maintained.

This perception is often linked to the absence of an open book approach. In the absence of such an approach clients begin to perceive after a year or two that they are not receiving value for money, possibly regardless of the true nature of the situation. Nor does the absence of an open book approach necessarily protect the profitability of the contract.

Despite the presence in most cases of a fixed price contract, over half of the outsourcing clients interviewed had re-negotiated the initial contract price. A minority of these re-negotiations took place because of changing organisational circumstances. However the major factor leading to re-negotiation was a feeling of inadequate value for money and in the majority of cases a reduction in contract pricing was achieved by the client.

Consequently while a fixed price contract offers a degree of price protection to the client, it appears to be inadequate to protect the vendor's position if the client feels that excessive profits are being made at their expense. Accordingly it may be in the interests of the vendor to adopt a more open approach to pricing initially. Once clients become suspicious of vendors' pricing they are likely to enter into particularly confrontational pricing exercises on contract renewal.

A more successful approach might be to regularly review contract pricing with the client. An example of this style of approach is Andersen Consulting's contract with BP Exploration for accounting services. The remuneration for this contract is based on a combination of transaction pricing and quality standards and is reviewed every three months. The contract appears to have been a success delivering both high service quality and considerably reduced service cost.

Clients also perceive that current levels of risk sharing by vendors are inadequate. Even in instances where shared risk/reward has been actively promoted by the vendor, clients still perceive that the vendor is not taking on a proportionate share of the risk.

C

New Service Types Necessitate Changes in Pricing Mechanism

So far the majority of outsourcing contracts have been dominated financially by the value of the mainframe assets involved and this has resulted in a strong emphasis on fixed price contracts.

However, the nature of services outsourced is now becoming much more diverse and this needs to be reflected in the pricing mechanisms adopted.

While vendors typically recognise this increased diversity and the relative strengths and weaknesses of the various pricing mechanisms, clients tend to be more conservative in their views and favour:

- Fixed price contracting as a means of establishing certainty of budgeting

- Resource usage based pricing as a means of ensuring competitive pricing between vendors and greater visibility of vendor cost.

While the majority of clients with fixed price contracts are satisfied with this approach, other clients would like to move to a more output-oriented style of pricing. This is potentially of highest benefit to the client where activities are being run down, for example the phasing out of a mainframe service or declining volumes of cheque processing in the banking sector.

Exhibit II-2 lists the pricing mechanisms currently favoured by outsourcing clients by service type.

Exhibit II-2

Favoured Outsourcing Pricing Mechanisms: Users

Service Type	Most Highly-Rated Pricing Mechanisms
Datacentre Operations	Fixed Price Resource-based
Desktop Services	Price per user Resource-based
Application Management	Resource-based Fixed price
Business Operations	Resource-based Business parameter-based

Source: INPUT

Clients are typically in favour of a price per user approach in the desktop environment. However pricing in the desktop services outsourcing market is still immature and one client reported being disturbed by the variance in desktop services pricing levels that are currently being quoted by vendors.

Many vendors are endeavouring to move towards risk/reward pricing mechanisms for their outsourcing contracts.

However in practice it can be difficult to agree the basis for vendor remuneration in these instances and in most contracts of this type to date, the risk/reward element accounts for only a small proportion of total vendor remuneration.

Another approach to risk/reward pricing that facilitates sharing between vendor and client is the use of joint ventures.

One example of this approach is Andersen Consulting's joint venture with Fiat New Holland's agricultural machinery group to manage logistics and distribution of spare parts for agricultural and construction equipment. The joint venture is 80% owned by New Holland and 20% by Andersen Consulting. The joint venture aims to take advantage of New Holland's warehousing and distribution expertise and Andersen Consulting's process reengineering and IT skills.

In the future, it is probable that pricing mechanisms will evolve from those listed above towards those proposed by IT function in Exhibit II-3.

Exhibit II-3

Future Pricing Mechanisms by Function

Function Outsourced	Future Pricing Mechanisms
Datacentre management	Fixed price Transaction-based for declining volumes
Desktop Services	Price per user
Application management	Value based shared risk/reward
Business operations	Transaction based Business metric based e.g. customer satisfaction

Source: INPUT

Fixed price mechanisms are most suitable for stable environments and resource, output-based and value-based pricing mechanisms most appropriate for dynamic situations such as application development in support of individual reengineering projects.

D
Clients & Vendors Have Differing Attitudes to Incentives and Penalties

Overall there is a lack of appreciation of the merits of value-based pricing within existing outsourcing clients.

This may be partly due to the differing perspectives of clients and vendors towards vendor incentives and penalties. These attitudes are contrasted in Exhibit II-3.

Exhibit II-4

Contrasting Attitudes to Incentives and Penalties

Clients	Vendors
Penalty clauses are necessary to ensure SLA targets are met	Penalty clauses show a lack of willingness to work together
Contract renewal is the vendor's incentive	Incentive payments are appropriate if targets are exceeded
Innovation is part of the vendor's business. It is a basic service element.	Innovation is high risk and should be rewarded with high margins

Source: INPUT

Overall clients tend to take the view that vendors' raison d'etre is to improve their use of IT. Otherwise why should they use an external vendor at all? Accordingly they typically perceive that a business value based approach is part of the basic package and tend to be dissatisfied with the level of vendor innovation if this fails to be delivered.

Accordingly clients can fail to appreciate why the vendor should receive a special level of remuneration just for providing the services at which they are supposed to excel.

Clients perceive that the vendor should be able to deliver superior service and innovation at a competitive price.

This view is particularly prevalent where operational SLAs are involved. Clients expect vendors to have the capability to meet the service levels contracted. When vendors fail to meet the contracted SLAs over a period of time, a typical reaction is for the client to want to use penalty payments. In addition, the client is probably sufficiently outraged at the service failure that they want the penalties to be large enough to make senior vendor managers pay attention to their problems. If the penalties in force are seen to be derisory, the client can feel especially helpless.

Some clients are prepared to pay incentives for early completion of projects, underbudget project delivery and service levels in excess of target SLAs. Other clients feel strongly that incentives should not be paid under any circumstances since:

- The vendor is only doing his job

- The SLA contracted was what the client required not a higher level of service

- Being paid for their services and possibly having the contract renewed is sufficient reward.

Vendors should be aware of the range of views held by clients on this topic. It is easy to offend clients by requesting bonuses that the client perceives to be unjustified.

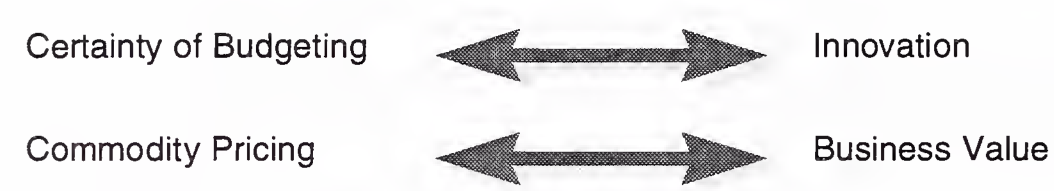
E

Clients Want Innovation AND Competitive Pricing

There are many conflicting demands in pricing outsourcing contracts. Some of these are listed in Exhibit II-4.

Exhibit II-5

Conflicting Demands: Pricing of Outsourcing Services



Source: INPUT

The ideal outsourcing pricing mechanism would combine all of these features and many more including declining IT expenditure.

However some of these conflicts need to be resolved by vendors. At one time it was possible for manufacturing companies to adopt a high-value/high price market position and successfully differentiate products away from the commodity end of the market. In recent years such strategies have been increasingly unsuccessful. The manufacturing sector has been moving towards a situation where manufacturers have had to combine high value, low lead-times, and low cost into the positioning of their products (better/quicker/cheaper). Such organisations are now endeavouring to move towards the concept of mass customisation.

This is a trend that the service sector must also follow. It is not acceptable for vendors to provide either business benefit or competitive pricing. Vendors now need to provide both.

Outsourcing clients would like vendors simultaneously:

- To deliver greater business value
- To assume more of the risk inherent in applying IT to the business
- To guarantee competitive pricing of service elements.

However, some of the vendors positioning themselves on the basis of greater business value and risk sharing are endeavouring to establish a premium position. Clients do not want this. They expect vendors to deliver the benefits outlined above while simultaneously pricing the service components involved at competitive market rates.

Overall there is a growth in the adoption by vendors of value-based pricing as the answer to the problems of insufficient delivery of business value and lack of innovation. However clients are suspicious of this approach and vendors must be aware of the need to demonstrate both business value and value for money within IT services.

In addition to value-based pricing, there are a number of common approaches to the problem of simultaneously delivering cost reduction and innovation, including:

- Using cost savings from legacy processes and IT functions to subsidise the introduction of new business processes and information systems

- Resetting service delivery agreements and price at very frequent intervals, for example quarterly as in the case of Andersen Consulting and BP Exploration.

The first example depends on the vendor's ability to switch the profile of service cost from one dominated by spending on maintaining legacy systems to a cost profile in which innovation in new processes, infrastructure, and systems takes precedence. Accordingly vendors using this approach tend to stress their full-service capability.

Overall, full service vendors will tend:

- To stress their ability to add business value

- To stress their ability to provide cost-effective IT services by reducing the expenditure on legacy systems and using the funds released for new systems development.

Niche vendors will need to combat this approach by either:

- Emphasising their ability to provide efficient infrastructure management

- Emphasising their ability to add business value within a particular range of business processes through application management or business operations outsourcing.

F

Pricing Needs to be Able to Accommodate Changes in the Pattern of Services Being Outsourced

Another key challenge for users is maintaining flexibility of outsourcing and its pricing.

In the future, pricing mechanisms must be flexible enough to cater for rapid changes in business process, including outsourcing of some business functions.

In principle, the decision to outsource should be driven by the need to maintain world-class business processes within the value chain. It follows that the decision on which areas within an organisation to outsource should be driven by:

- Consideration of the need to reengineer the organisation's value chain
- Benchmarking of in-house capability for the required business processes/functions (both effectiveness and efficiency)
- Willingness or ability to invest in each process/function to achieve world-class capability
- The level of interaction required between processes/functions.

It is only once this process has been carried out that the various business process elements to be outsourced can be identified. Once identified they can be grouped into families for outsourcing and contracts awarded.

It is at this stage that decisions on outsourcing supporting services such as IT should ideally be made. However many organisations will have already outsourced elements of their IT function, and such outsourcing patterns may be inconsistent with the new requirement to outsource business processes unless all business functions and IT functions are to be outsourced to the same vendor.

This can have considerable implications for the terms and pricing of IT outsourcing contracts and for the pattern of IT outsourcing. In practice a wide range of outsourcing patterns are possible, such that clients may wish to outsource any combination of:

- IT infrastructure components (either separately or bundled)
- Application support and development
- Business process.

Initially it seems theoretically desirable that any business operations vendor should take over responsibility for provision of the IT systems that support the process/function being outsourced. However it is arguably more important for the effectiveness of the business process that the business operations vendor controls the selection of applications than that they provide operational IT services related to these functions.

In other circumstances the operations of the business operations vendor might be relatively unimpaired by using existing software.

For example this situation is commonplace in U.K. local government. By way of illustration, Capita is a supplier of managed services to Bromley and Westminster local authorities yet the IT at these authorities is outsourced to another vendor. In both cases the IT outsourcing contracts were written to accommodate in-house users of services not third parties. The introduction of a third-party has implications for the IT outsourcing contract terms and pricing which will need to be changed at some point to accommodate this situation.

In this instance, although the IT systems are important they are not perceived to be the major determinant of success in delivering the business process. Elsewhere it might be more critical to delivering world-class business process capability that the vendor installs their own applications.

Even then it may not be necessary for the vendor to provide operational management of these services. Indeed it might be important for integration with other systems that the applications be installed on customer-specific equipment, perhaps managed by a further outsourcing vendor.

Conversely all the IT related to the business operations contract might be removed to the business operations vendor's premises, enabling them to achieve better economies of scale through shared facilities. In this instance, these systems/applications are effectively removed from the client's infrastructure and substituted with an electronic trading style interface.

Accordingly, a wide range of IT outsourcing patterns may need to co-exist with business operations outsourcing.

However, whatever style or combination of services is outsourced, any IT outsourcing contracts in force need to be sufficiently flexible to accommodate such situations. One of the historical flaws with IT infrastructure outsourcing contracts has been that the contract terms have acted as an impediment to change. It is essential that any IT outsourcing contracts are worded and priced in such a way as to accommodate business operations contracts being introduced with the resulting potential impact on both applications and infrastructure management.

Any pricing mechanisms used need to be suitable for the activity being outsourced and also provide a high level of flexibility in changing the pattern of outsourcing.

For outsourcing to be successful in the future, the pricing of outsourcing contracts must:

- Facilitate, not hinder, business change
- Be compatible with multi-vendor outsourcing towards a common set of goals
- Have sufficient flexibility to accommodate changing outsourcing patterns.

III

Client Attitudes to Pricing of Outsourcing Contracts

One of the traditional weaknesses in the pricing of outsourcing contracts has been their emphasis on delivering IT service cost reduction rather than business value. Many outsourcing vendors are reacting to this scenario and its implications for vendor profitability by trying to introduce more value-based models emphasising shared risk/reward.

However, outsourcing clients are currently less enthusiastic about this new approach.

The majority of well-established IT outsourcing contracts use predominantly fixed price pricing mechanisms. Outsourcing clients are typically satisfied with this style of pricing since it gives them a high level of cost certainty. While outsourcing clients would like to introduce more flexibility into the pricing of their outsourcing contracts, their immediate concerns relate primarily to improving traditional pricing mechanisms in traditional environments. In particular, clients would like vendors to:

- Improve the visibility of their cost structures so as to demonstrate value for money
- Deliver greater continuity of cost reduction throughout the life of the contract
- Retain fixed price and resource-based pricing mechanisms that provide the benefits of cost certainty and cost visibility.

Similarly while vendors tend to favour the use of incentive pricing to encourage the delivery of business benefits and superior service levels, clients tend to favour penalty clauses to ensure that the vendor adheres to the agreed service levels.

While vendors increasingly wish to be judged on their business contributions, clients typically have difficulty in distinguishing between vendors in terms of their business process improvement capability and will continue to assess vendors primarily on their IT capabilities.

A
Clients Are Satisfied with the Pricing of Traditional IT Outsourcing

Exhibit III-1 lists the number of organisations within the survey that were outsourcing each service type.

Exhibit III-1

Outsourcing Usage by Service Type

Service Component	Number of Organisations Outsourcing
Mainframe Operations	27
Corporate Data Network	22
Desktop Services	15
Application support & maintenance	13
New systems development	10
Business functions	5

Source: INPUT

The sample is dominated by organisations outsourcing mainframe operations. This function is outsourced by approximately 90% of the organisations surveyed. The remaining organisations typically outsource mid-range equipment.

Approximately 70% of the sample also outsource their corporate data network. At present this function is overwhelmingly managed by the same vendor that performs mainframe operations. Only one organisation had contracted its network management to a specialist vendor.

By contrast, one-third of those organisations outsourcing their desktop services use different vendors for mainframe operations and desktop services.

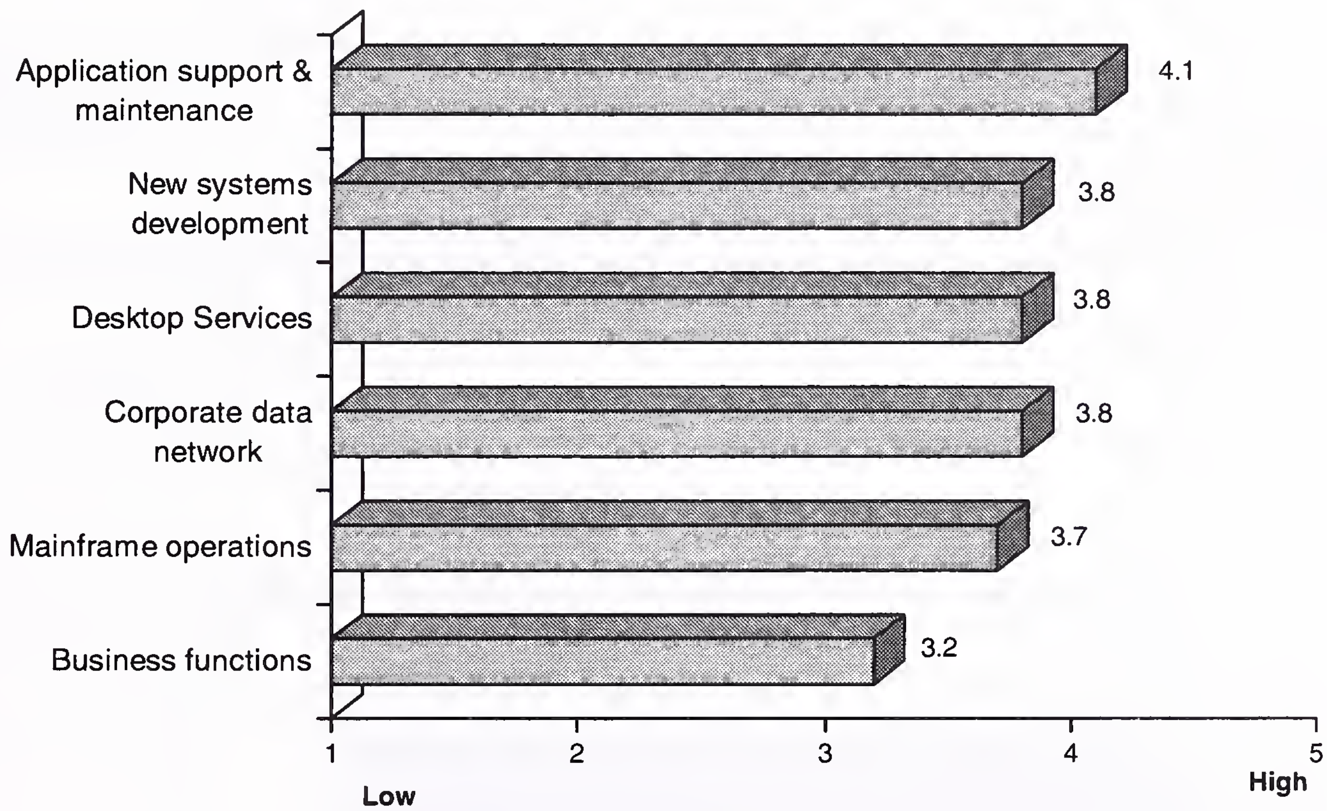
Within this survey, application management tended to be highly bundled with mainframe operations.

The high level of service bundling within this sample is important to note because it will have a potential impact on the pricing mechanism used, potentially constraining the variety of pricing mechanism that might be found in desktop services and application management contracts.

Exhibit III-2 shows clients' current level of satisfaction with the pricing of their outsourcing contracts by service type.

Exhibit III-2

Satisfaction with Pricing by Service Type



Sample of 31 respondents. Standard error = 0.2 *Source: INPUT*

Overall the satisfaction levels are medium to high. The sole exception apparently is the pricing of business operations outsourcing. However the sample here is much lower than for the other functions, making it difficult to reach any firm conclusions.

Exhibit II-3 lists the number of organisations perceiving that they received consultancy services within their outsourcing contracts.

Exhibit III-3

Usage of Consultancy Services

Service Component	Number of Organisations Outsourcing
BPR Consultancy	3
IT Strategy Consultancy	5
Other IT Consultancy	6

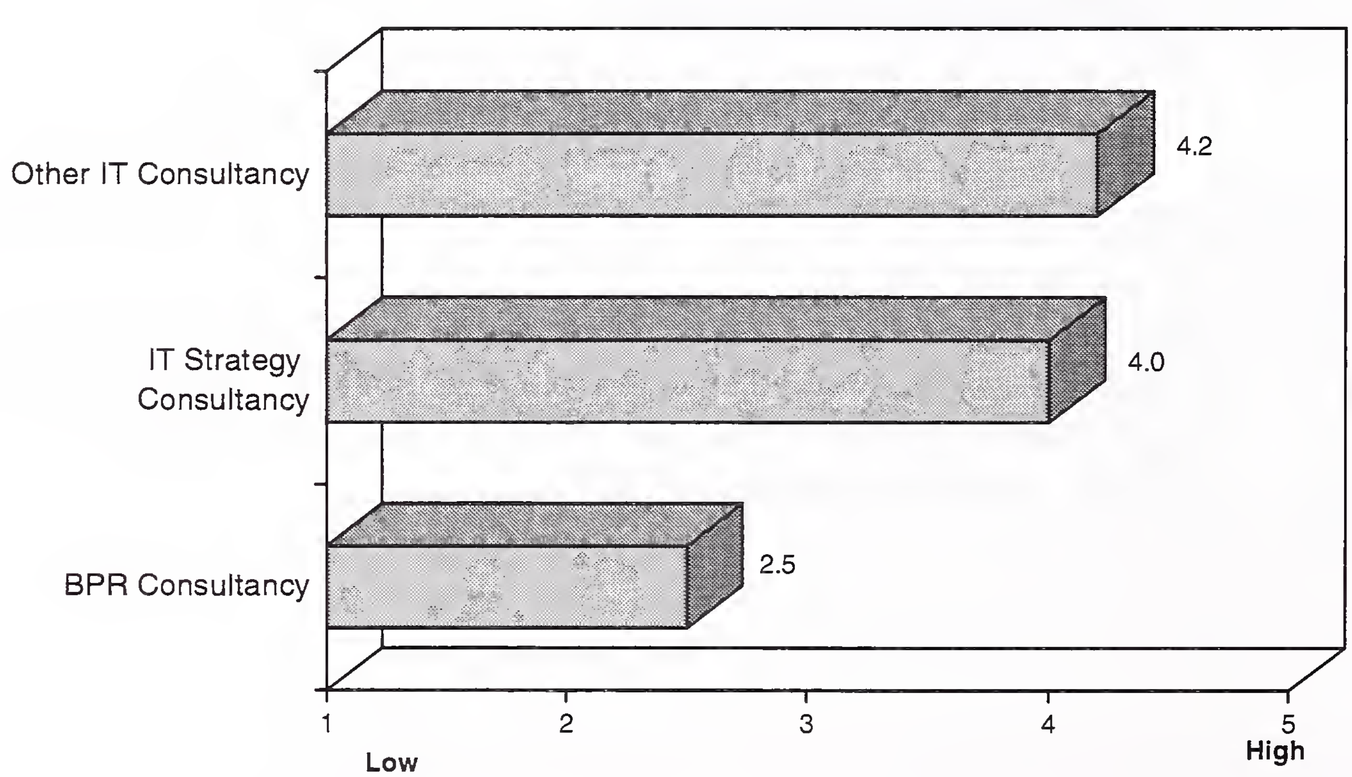
Source: INPUT

Overall only a small proportion of organisations perceived consultancy services to be part of the outsourcing service they received.

Exhibit III-4 lists their level of satisfaction with the pricing of these services.

Exhibit III-4

Satisfaction with Pricing of Consultancy Services



Sample of 6 respondents

Source: INPUT

These results suggest that clients are very satisfied with the pricing of IT consultancy services, but would like to see changes in the pricing for business reengineering consultancy. However, only two respondents provided ratings for the pricing of BPR consultancy, neither of whom were particularly satisfied.

B
Clients Require Improved Flexibility and Cost Visibility

Exhibit III-5 lists the profile of pricing methods currently used by clients for data centre outsourcing contracts.

Exhibit III-5

Pricing Methods for Datacentre Services

Pricing Method	Number Using	Proportion (%)
Fixed price	18	70
Resource based	5	20
Fixed within resource constraints	2	7
Fixed & value-based	1	4

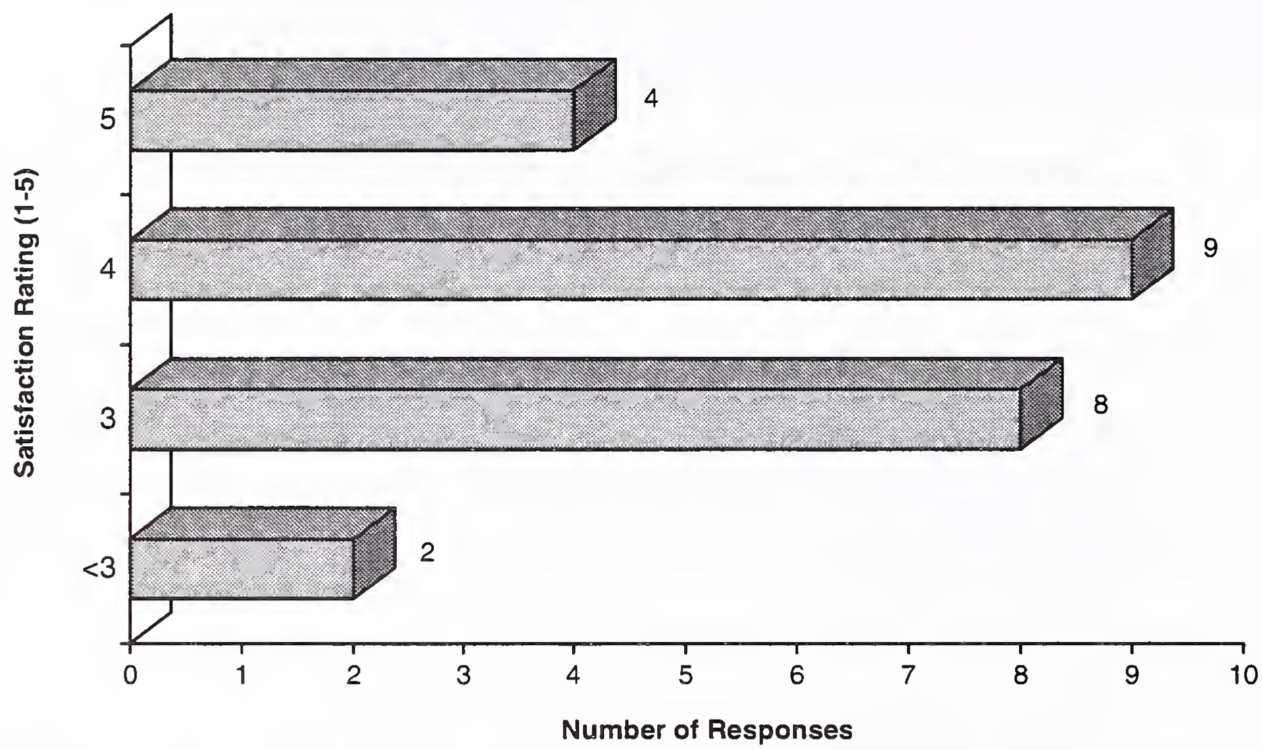
Source: INPUT

The majority of clients used a fixed price pricing mechanism. However a significant minority used a mechanism based on resource usage. This latter group tended to be slightly more satisfied (average rating 4.0) than those that used a predominantly fixed price mechanism (3.7).

The profile of satisfaction amongst clients using a fixed price approach for datacentre operations is listed in Exhibit III-6.

Exhibit III-6

Satisfaction with Fixed Price Approach to Datacentre Services



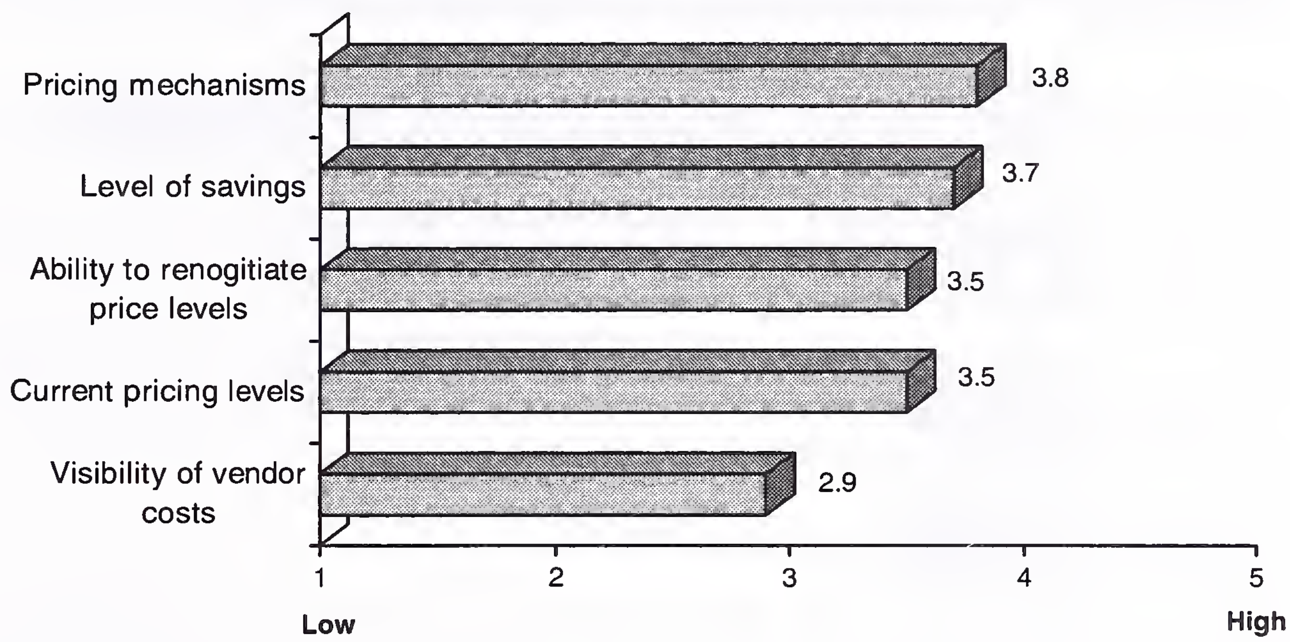
Sample of 24 respondents. *Source: INPUT*

Less than 10% of clients are dissatisfied with the fixed price approach. However, this approach is only moderately accepted by a third of clients.

Exhibit III-7 lists client satisfaction with various pricing attributes.

Exhibit III-7

Satisfaction with Pricing Attributes



Sample of 31 respondents. Standard error = 0.2 *Source: INPUT*

Clients are generally satisfied with the pricing mechanism used and with the level of savings that they have achieved.

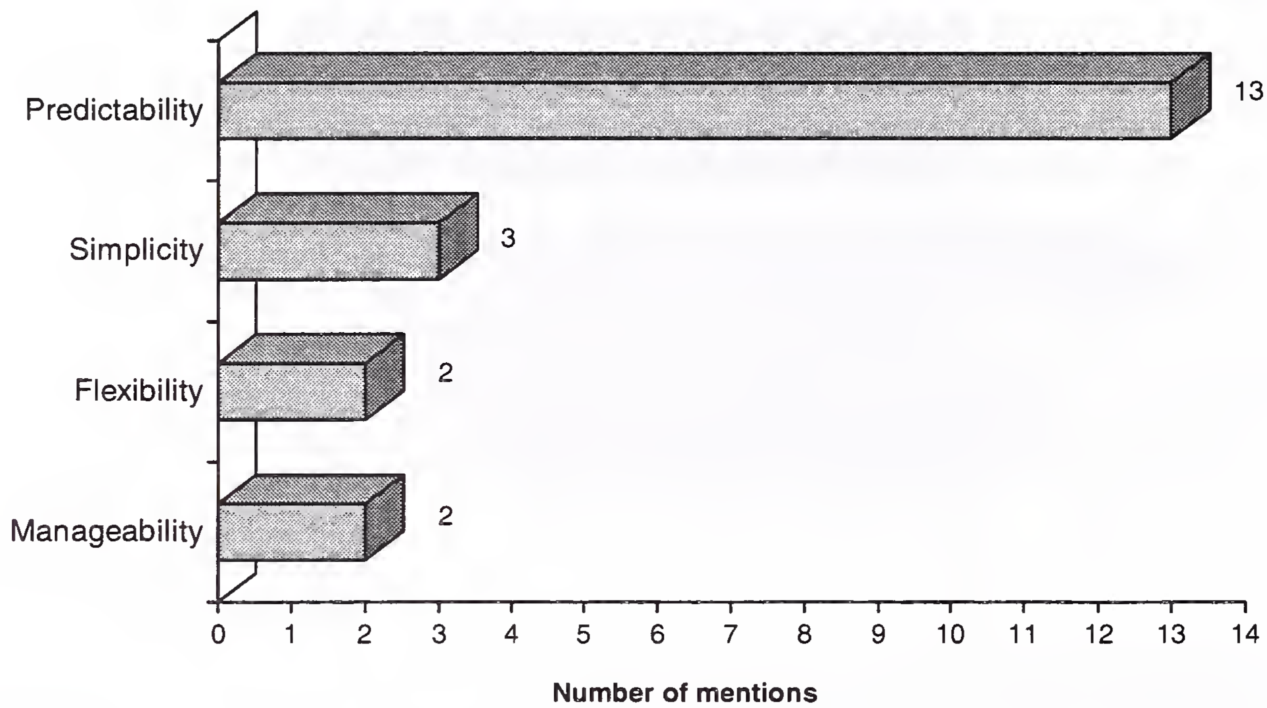
However, it appears that clients often become less satisfied with contract price over the life of an outsourcing contract and would like a greater opportunity to re-negotiate the contract price.

However, the one area of clear dissatisfaction is the visibility of vendor costs. As found in earlier INPUT studies, clients that do not have a clear understanding of vendor costs tend to become very suspicious of vendor profitability and perceive that the vendor is making excessive profits at their expense. This feeling is particularly evident several years into an outsourcing contract once any initial cost savings achieved have begun to be taken for granted.

The principal aspects of outsourcing contract pricing mechanisms that clients liked are listed in Exhibit III-8.

Exhibit III-8

Likes: Current Pricing Mechanisms



Sample of 31 respondents. *Source: INPUT*

It is important in interpreting these findings to remember that the majority of the contracts being considered are fixed price contracts.

Fixed price contracts have a number of disadvantages but these tend to be outweighed in the perception of clients by one simple consideration: the certainty and ease of budgeting derived from fixed price approaches.

Typical comments from outsourcing clients included:

Fixed price gives easy budget management

It's manageable and you know what your costs will be for the year ahead

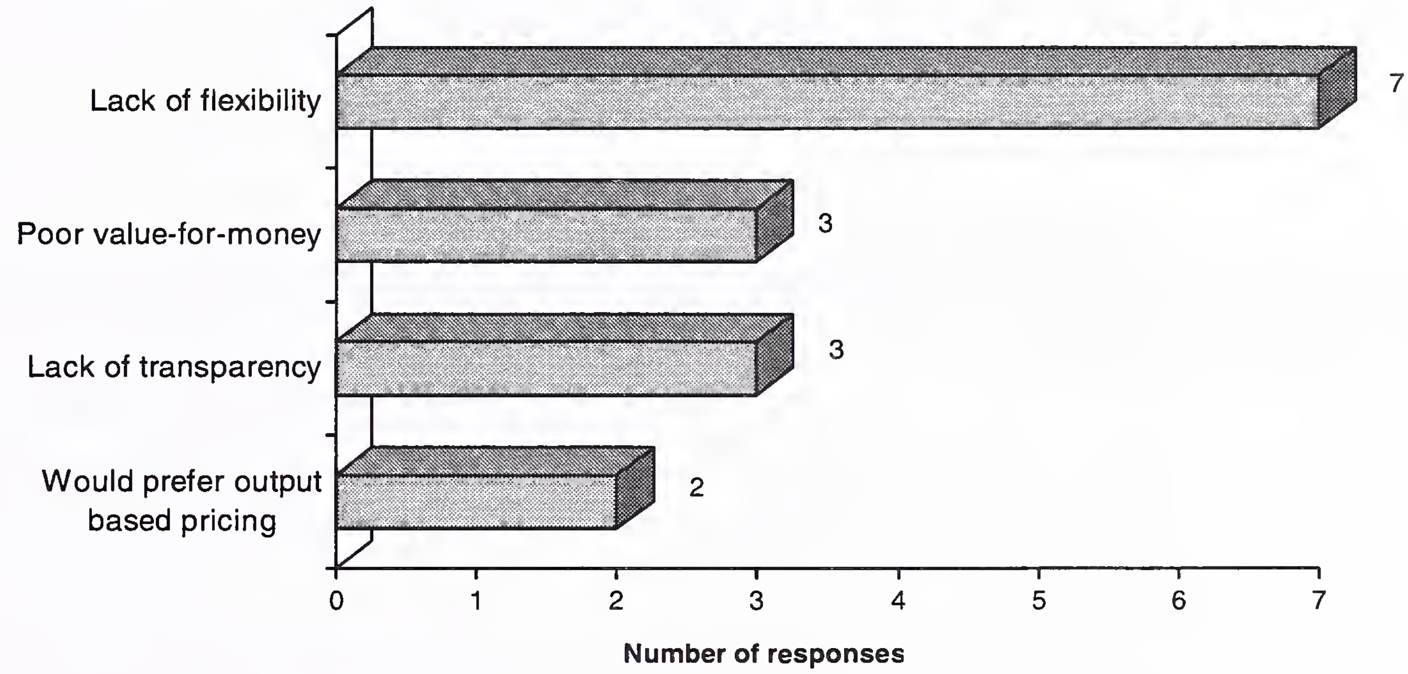
At least you know what you will pay with fixed price

However, resource based pricing approaches appear to give clients greater re-assurance that they are getting value for money than fixed price mechanisms.

Outsourcing clients principal dislikes concerning the pricing mechanisms used are listed in Exhibit III-9.

Exhibit III-9

Dislikes: Current Pricing Mechanisms



Sample of 31 respondents. *Source: INPUT*

The most important concern is the lack of flexibility inherent in fixed price contracts. In this respect, outsourcing clients are in danger of paying a high price in return for certainty of future payments.

One of the principal criticisms of outsourcing is that it can often act as an impediment to, rather than as a facilitator of, change. Fixed price contracts are one of the major reasons for this.

Comments that illustrate this point from representatives of organisations with fixed price outsourcing contracts include:

This approach is inflexible, restricting future growth and development.

Sometimes the duration of a fixed price contract is excessive

Once you have settled a fixed price, there is no going back.

We are stuck with a fixed price element that doesn't change with our level of output.

Rather than using outsourcing to advance the application of IT within the client organisation, there is a danger in fixed price contracts that the client will in effect exchange cost savings for a slower rate of technological change than might be desirable.

It is clear from some lengthy contracts, particularly those of 10 years or more that the apparent cost savings are achieved in exchange for moderate advancement, and considerable inflexibility, in the use of IT. If the client realises in mid-contract that the organisation will not be proceeding down the technological route predicted within the contract years earlier, it will potentially be an expensive decision for the organisation. The alternative is to restrict the organisation's use of IT considerably.

Vendors need to find a way of redrafting their contracts to avoid these problems becoming imposed on their clients.

The perception of inadequate value for money is often linked to low visibility of vendor costs and in some instances the basis for the calculation of the price is unclear to clients.

There appears to be a growing belief amongst users that pricing should be output-based rather than input-based. Several clients in the survey wanted to transfer from a fixed price approach to an output-based approach. In one instance, the client perceived that the vendor was being obstructive in facilitating this transition as is indicated by the following comments:

We can't move to output measures. The vendor finds them hard to accommodate. In addition, the vendor doesn't want to use output measures and so quotes at a prohibitive rate.

C

Vendors Must Demonstrate Ongoing Cost Reduction

Exhibit III-10 lists the difference between importance and satisfaction ratings for a range of pricing attributes.

Exhibit III-10

Satisfaction with Pricing Attributes

Attribute	Importance Rating	Satisfaction Rating	Difference
Ability to deliver ongoing cost reduction	4.4	3.0	1.4
Ability to deliver initial cost reduction	4.2	3.5	0.7
Open book approach	3.9	3.2	0.7
Incentives to encourage vendor creativity	3.4	2.8	0.6
Sharing of risk with vendor	3.7	3.2	0.5
Links to business process improvement	3.7	3.2	0.5
Links to business parameters	3.6	3.1	0.5
Links to business success	3.6	3.2	0.4
Payback clauses	3.5	3.4	0.1

Source: INPUT

The perception that outsourcing vendors do not deliver ongoing cost reduction remains a major problem for vendors. While this perception remains, it is probable that clients will approach contract renewal in a adversarial frame of mind and encourage the vendor's major competitors to provide strongly price-competitive proposals.

Vendors are perceived to be better at providing cost reductions at the beginning of contracts. However there is perceived to be scope for improvement even at this stage.

While many vendors have apparently adopted an open book approach to outsourcing contracts, this is still an area of low satisfaction with clients. However, it is unclear whether this is because some vendors do not adopt such an approach or because clients distrust the validity of the information that they are given.

Clearly one of the major challenges facing outsourcing vendors is the need to innovate in the use of IT to deliver real business benefit to the client organisation. Current outsourcing pricing mechanisms are perceived to be inadequate to encourage vendor creativity and to encourage risk sharing.

However, the client perspective is potentially very different from the vendor perspective at this point. While a number of vendors appear to believe that innovation is a major departure from the norm in return for which they should receive high profit levels, many clients perceive that it is the vendor's duty to deliver innovation and that it is a basic service for which they are already being well-remunerated.

Exhibit III-11 lists the frequency with which organisations conduct pricing reviews of the outsourcing services received.

Exhibit III-11

Frequency of Pricing Reviews

Frequency of pricing reviews	Number of mentions	Proportion (%)
Monthly	1	3
Quarterly	1	3
Six monthly	2	6
Annually	13	42
Two - three years	3	10
Four - five years	2	6
At contract end	7	23
As necessary	2	6
Total	31	100

Source: INPUT

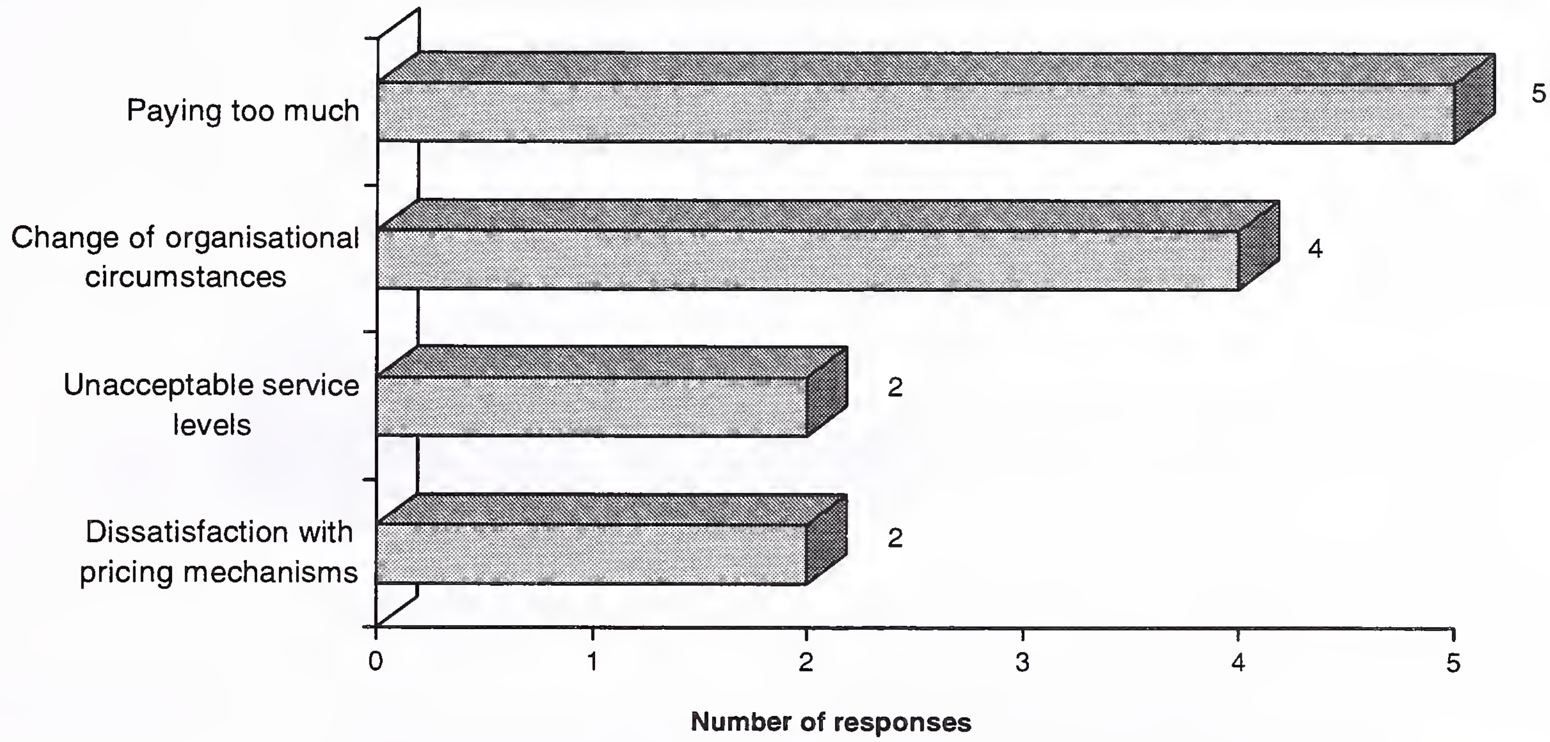
The norm appears to an annual review of the contract. However, nearly a quarter of organisations that outsource IT functions only review the contract pricing at the end of the contract.

This is potentially dangerous for vendors since such a situation could easily lead to a high build-up of client dissatisfaction with contract pricing.

However, over half of the organisations surveyed claimed to have initiated the re-negotiation of the price of an outsourcing contract. The principal driving forces behind the need for re-negotiation are listed in Exhibit III-12.

Exhibit III-12

Reasons for Price Negotiation



Sample of 31 respondents. *Source: INPUT*

The principal reason for re-negotiating prices is a perception of inadequate value for money. This viewpoint mainly arises from a perception of excessive charging by the vendor, but can also arise in circumstances where the agreed service levels are not being met.

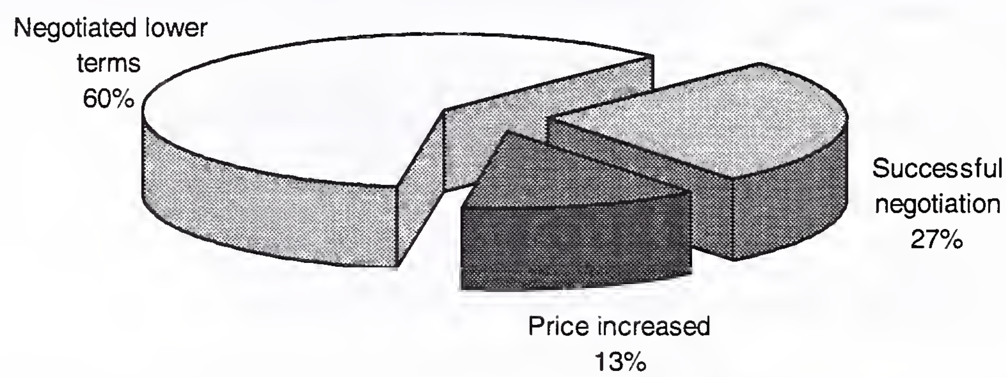
However in a minority of cases, contract pricing had been re-negotiated to accommodate the changing circumstances of the client organisation. This was rare in the private sector but more common in local government in the U.K. where local authority budgets are subject to changes imposed by central government. In these instances, the vendor appears to have taken steps to modify the contract pricing in line with the new budgets available to the local authority.

Only one private sector organisation made the basic point that the nature of their business changed over time and that all suppliers were expected to recognise this and adapt accordingly. This situation needs to become more widespread in outsourcing is to take on a more pro-active role in the application of IT in the future.

The outcomes of these re-negotiations are listed in Exhibit III-13.

Exhibit III-13

Outcome of Negotiation



Sample of 15 respondents. *Source: INPUT*

The focus of these negotiations is predominantly on reducing the level of pricing rather than introducing greater flexibility into the contract.

Overall 13 out of the 15 respondents reported that the negotiations were successful with the majority of these clients achieving lower charges than previously.

Only one client had intentionally negotiated a higher price and this was in return for higher service levels rather than increased flexibility or a more pro-active stance.

Within this study, only one client had experience of a value-based approach to contract pricing. The level of satisfaction with pricing in this case was lower than the averages where fixed price or resource based pricing mechanisms were used. The client appeared to have doubts about the reality of this risk/reward approach stating that the partnership factor was missing from the vendor's risk sharing approach.

Overall the client felt that there was too much emphasis within the contract on vendor profit and stated that *there is a fine line between vendor margins and customer satisfaction*.

The client in this case would like ideally like to implement a combination of greater risk sharing by the vendor and more competitive (marketplace) pricing for the IT services purchased.

At present the client perceives that they have not achieved a sufficiently pro-active, risk-sharing stance from the vendor but have lost the ability to purchase truly price-competitive services.

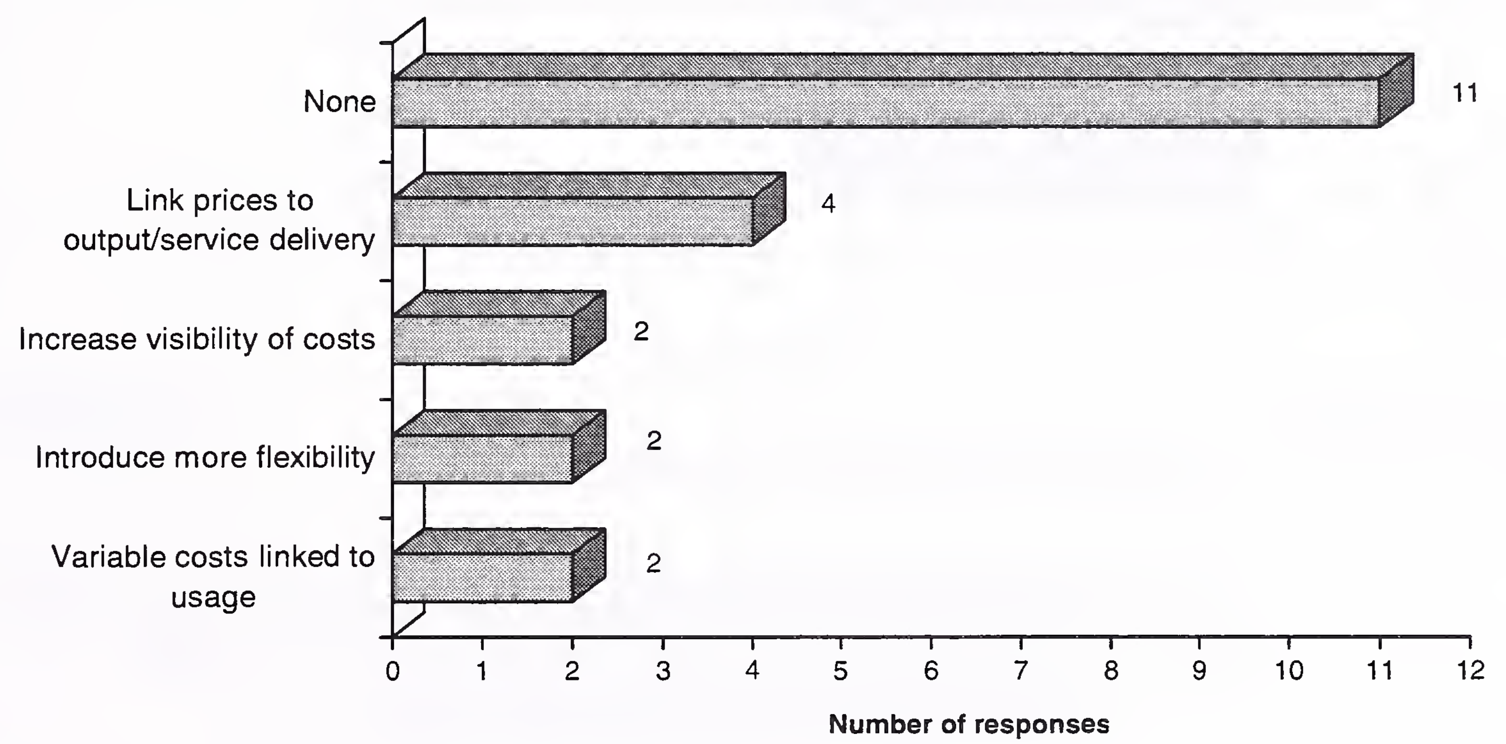
The message for vendors is that users do not see why a pro-active stance cannot be combined with keen pricing. In addition if the vendor is stressing its risk-sharing capability, clients would like to see higher levels of risk sharing taking place.

Overall 14 out of the 31 users of outsourcing interviewed would change the pricing approach used if they had the opportunity to re-negotiate the contract today.

Exhibit III-14 lists the main ways in which clients would like to change the pricing approach within their outsourcing contracts.

Exhibit III-14

How Clients Would Like to Change Pricing Approach



Sample of 31 respondents. *Source: INPUT*

Ten out of the eighteen respondents already using a largely fixed price approach favour retaining this pricing mechanism.

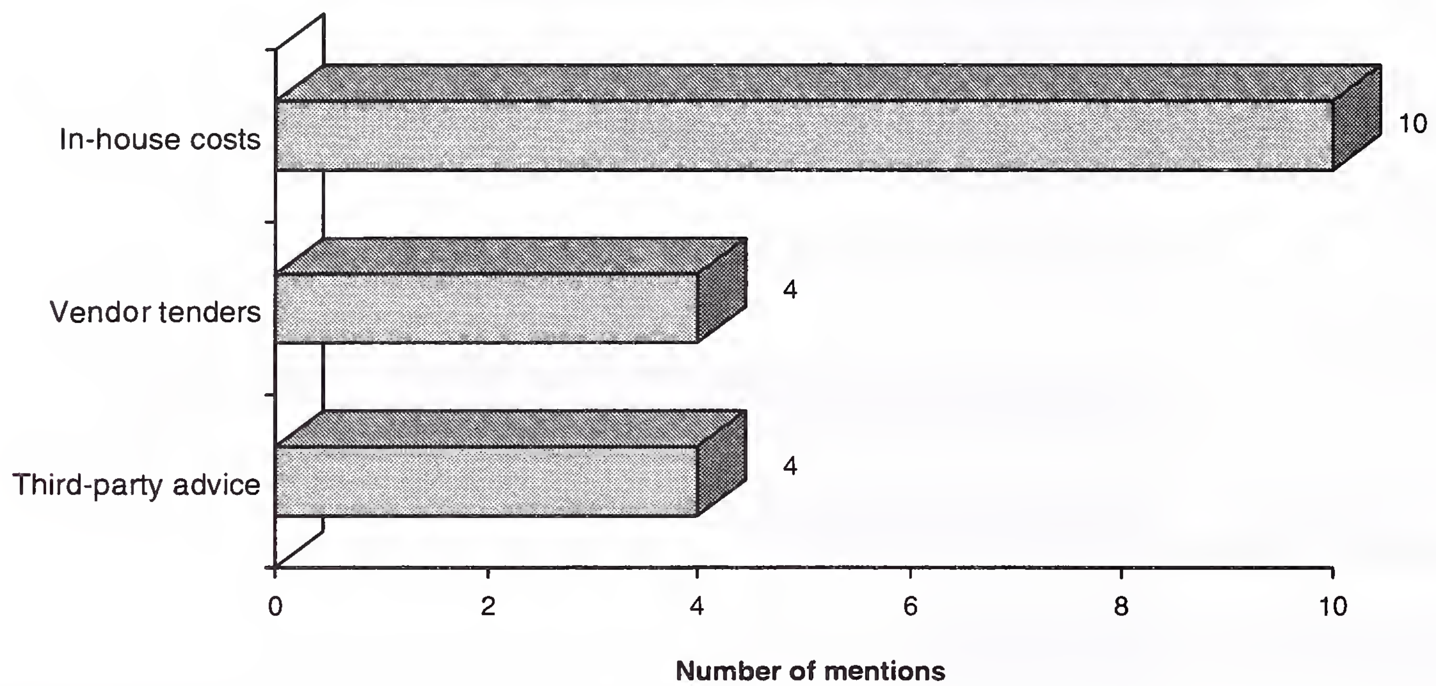
However, there are signs that clients are beginning to think in terms of a more output-oriented approach to pricing.

Clients would also like more visibility of costs to provide re-assurance that they are receiving good value for money throughout the life of the contract and not just in the early stages of the contract.

Twenty-three out of thirty clients stated that they had a benchmark of how much outsourcing should cost when negotiating their existing outsourcing contract. The bases for these initial benchmarks are listed in Exhibit III-15.

Exhibit III-15

Benchmark for Initial Contract Pricing



Sample of 31 respondents. *Source: INPUT*

Comparisons were principally based on prevailing in-house costs, though a minority of clients acquired third-party advice and others took a wide range of vendor quotations to ensure competitive vendor pricing.

D

Outsourcing Clients Favour Fixed and Resource Based Pricing Mechanisms

Clients were also asked unprompted which pricing mechanisms they perceived to be most appropriate for each category of outsourcing service and to rate the suitability of each of a number of prompted options.

The results for datacentre services are listed in Exhibits III-16 and III-17.

Exhibit III-16

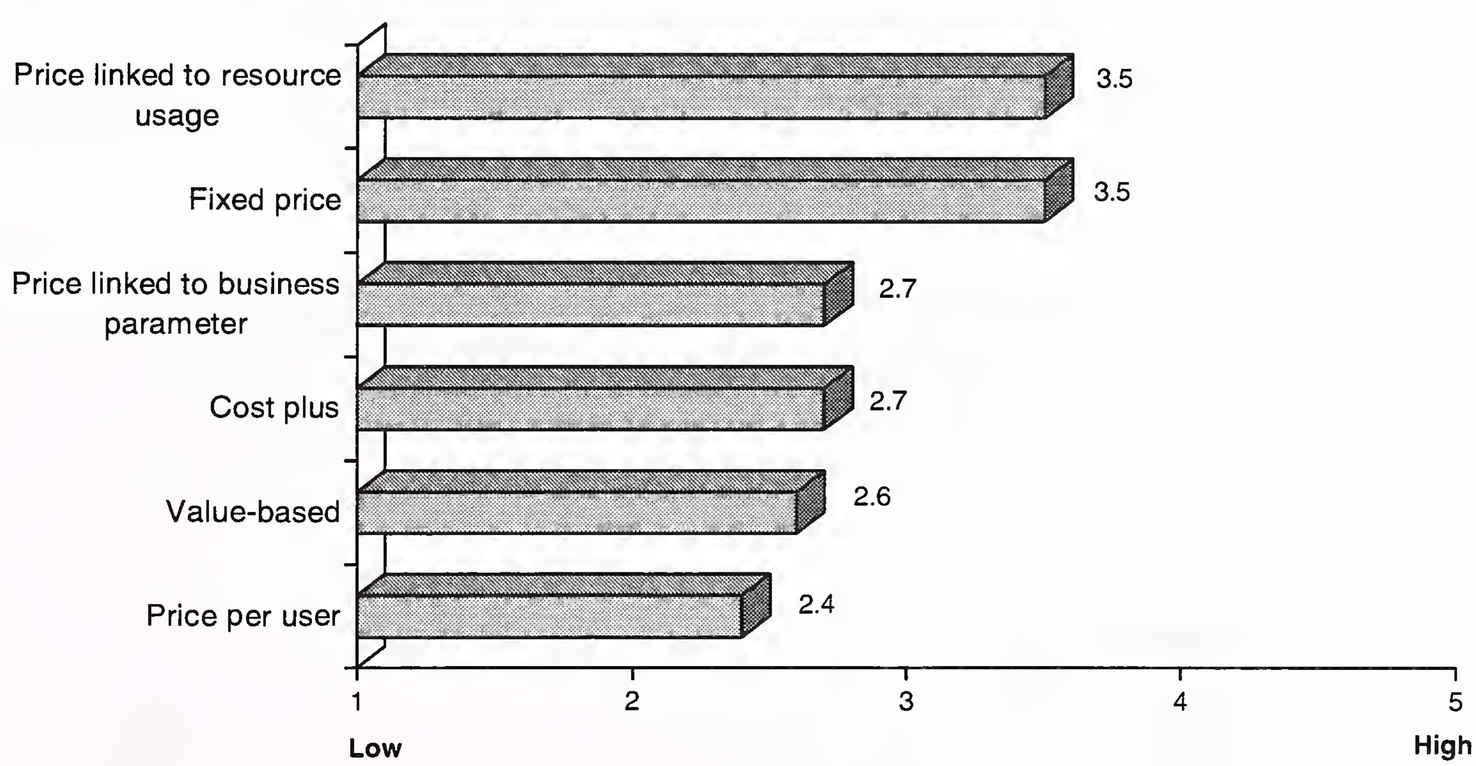
Favoured Pricing Mechanisms: Datacentre Services

Favoured pricing mechanism	Number of mentions	Proportion (%)
Fixed price	12	60
Resource usage	6	30
Business volumes	2	10
Total	20	100

Source: INPUT

Exhibit III-17

Suitability for Datacentre Services



Sample of 27 respondents. Standard error = 0.2 *Source: INPUT*

Fixed price and usage based pricing are the most popular pricing mechanisms for datacentre management services.

Fixed prices have the advantages of certainty and simplicity discussed earlier and are often perceived to deliver the highest cost savings. On the other hand in instances of declining mainframe usage, usage based pricing reassures the client that the price is being adjusted accordingly. Usage based pricing is also potentially more reassuring in terms of understanding the basis of vendor charges and can lead to higher visibility of costs.

In some cases, pricing linked to the number of business transactions can be attractive. This form of pricing will be particularly attractive to clients where:

- The number of transactions is expected to decline, for example cheque processing

- A declining charge per business transaction is incorporated in the pricing mechanism.

Value-based pricing where an element of the price is based on achievement of particular business metrics such as an increase in stock turn or a reduction in delivery time is not perceived to be particularly relevant to datacentre outsourcing. However this style of pricing is sometimes incorporated in contracts in addition to a number of pricing mechanisms based on more traditional IT service criteria.

Exhibits III-18 and III-19 list client perceptions of the most appropriate pricing mechanisms for desktop services outsourcing.

Exhibit III-18

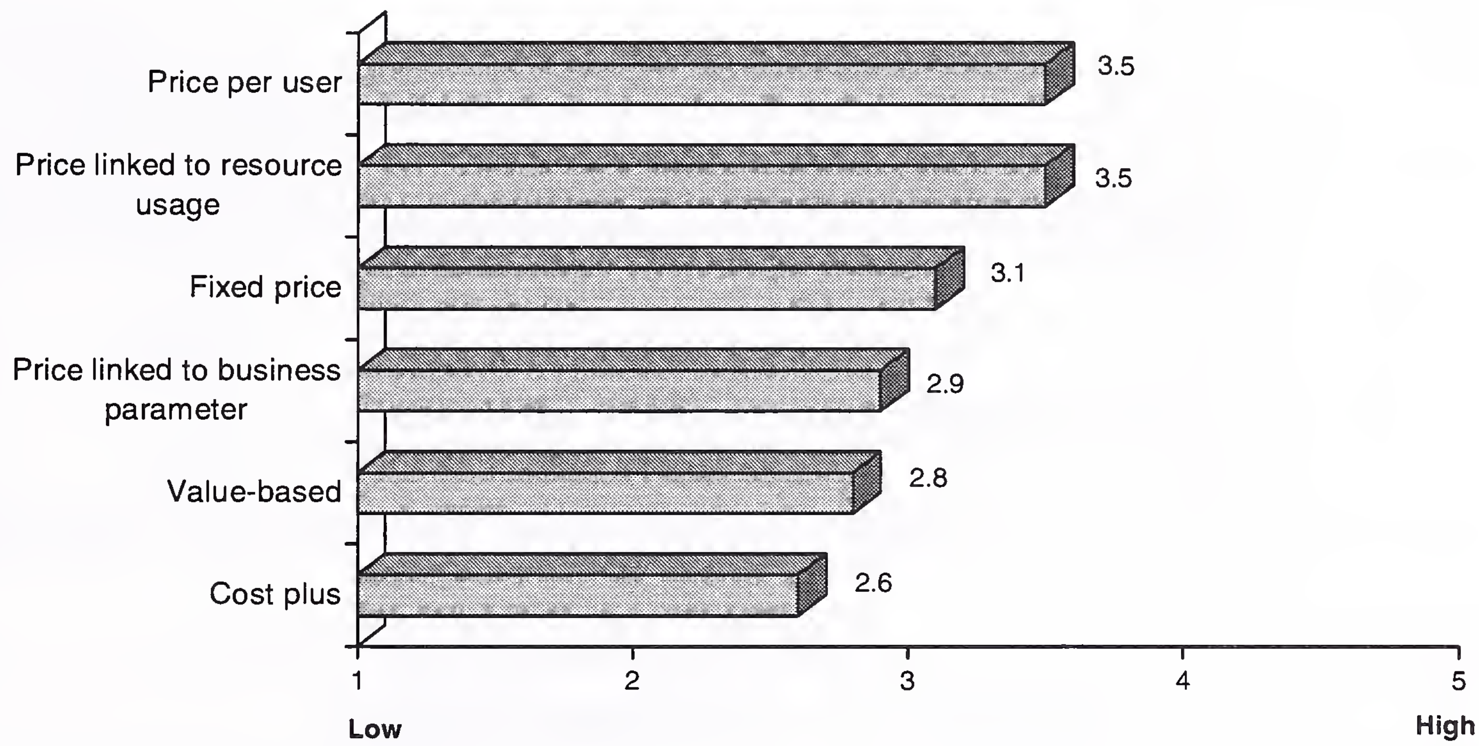
Favoured Pricing Mechanisms: Desktop Services

Favoured pricing mechanism	Number of mentions	Proportion (%)
Fixed	8	38
Price per user or PC	6	29
Resource usage	6	29
Business benefit	1	5
Total	21	100

Source: INPUT

Exhibit III-19

Suitability for Desktop Services



Sample of 19 respondents. Standard error = 0.2 *Source: INPUT*

Much of the present desktop services activity is embedded within wider outsourcing contracts largely dominated by fixed price pricing regimes and this may partly explain the high number of mentions for the fixed price approach.

However, in terms of ratings, clients favoured:

- Pricing on the basis on the number of PCs or users
- Pricing on the basis of the amount of support resource required, typically manpower.

Exhibits III-20 and III-21 list client perceptions of the most appropriate pricing mechanisms for application management.

Exhibit III-20

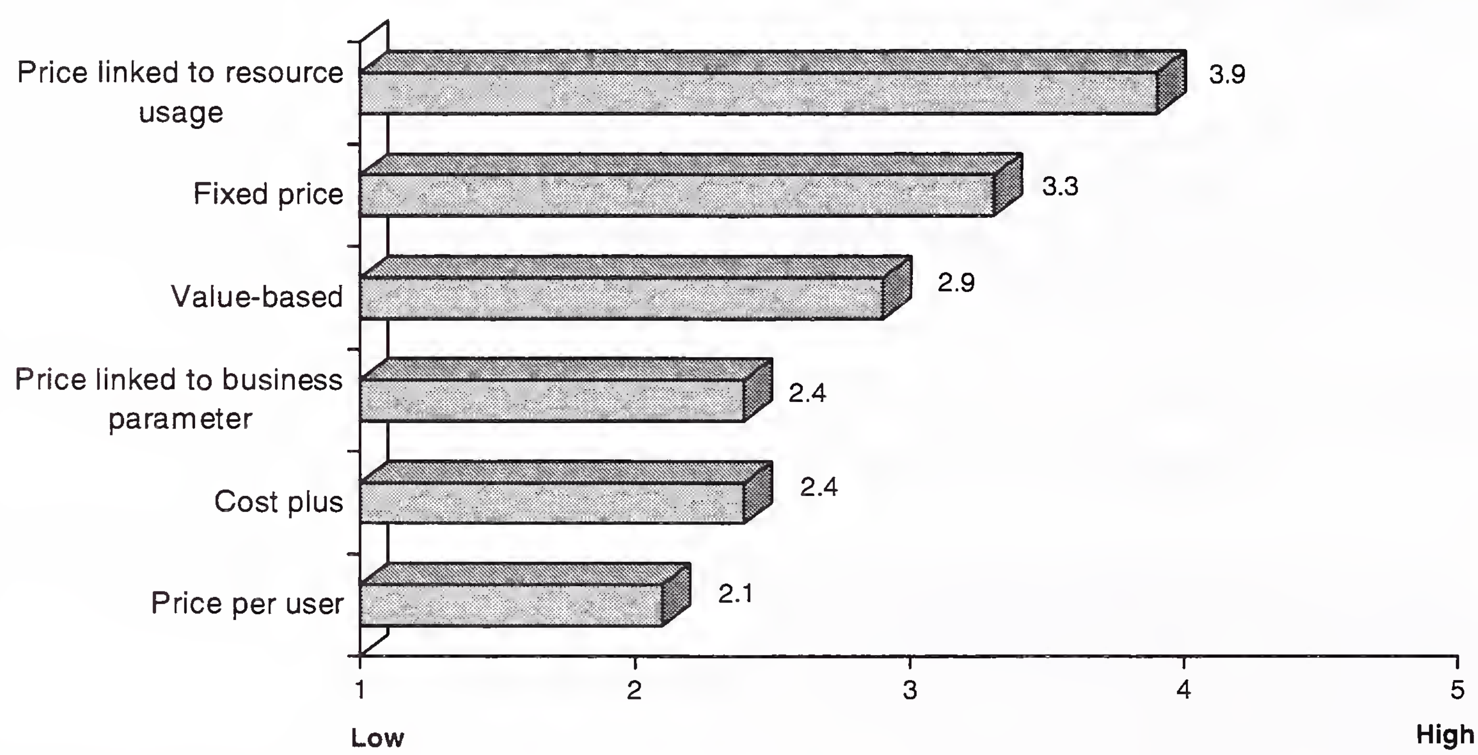
Favoured Pricing Mechanisms: Application Management

Favoured pricing mechanism	Number of mentions	Proportion (%)
Fixed	8	47
T&M	8	47
Business benefit related	1	6
Total	17	100

Source: INPUT

Exhibit III-21

Suitability for Application Management



Sample of 15 respondents. Standard error = 0.2

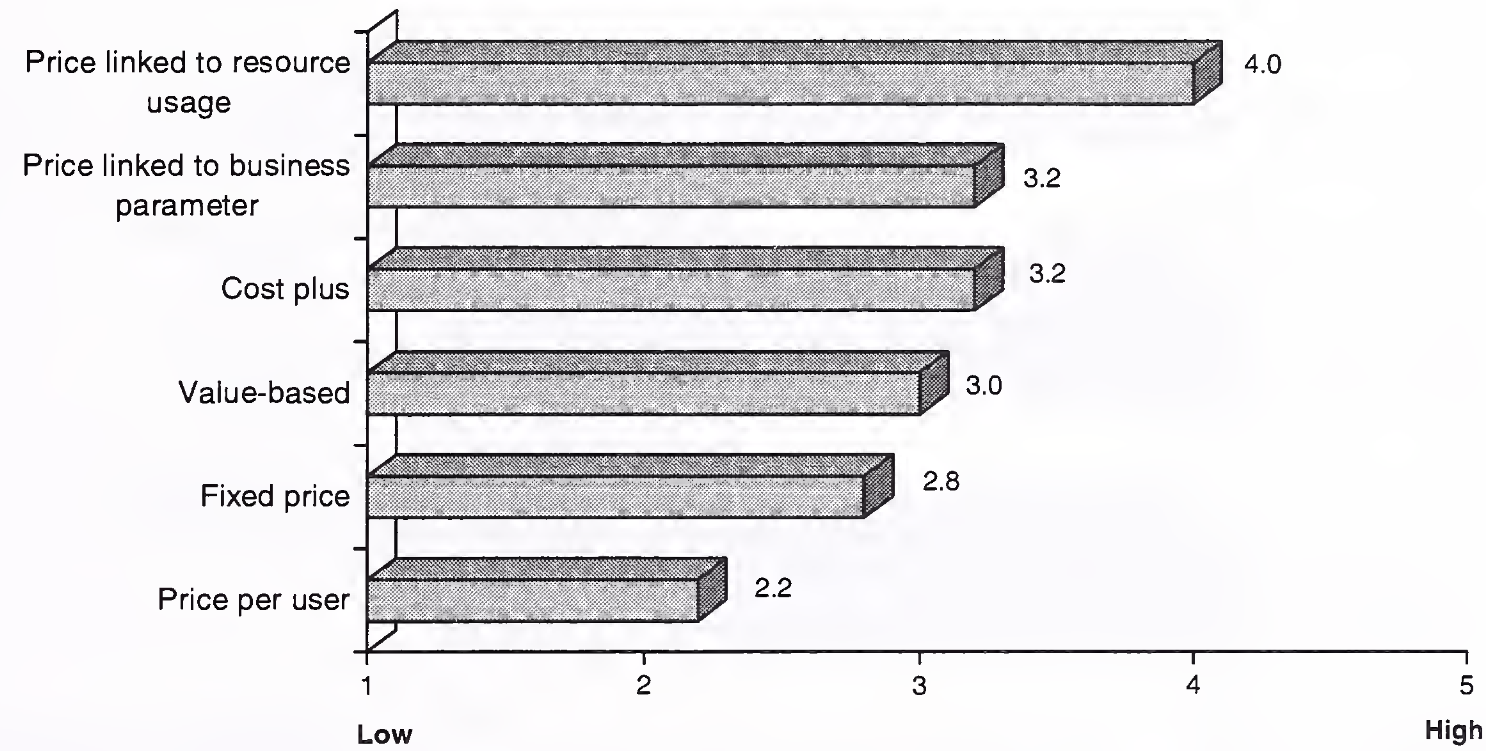
Source: INPUT

It might be expected that value-based pricing would be perceived to be comparatively appropriate in the area of application management. However, even in this area, the concept is less well received than time and materials or fixed price mechanisms.

Exhibit III-22 lists client perceptions of the most appropriate pricing mechanisms for business operations.

Exhibit III-22

Suitability for Business Operations



Sample of 15 respondents. Standard error = 0.2 *Source: INPUT*

Business operations outsourcing is potentially the area that is best suited to linking the price to business parameters. However, even in this area, there currently remains a perception that pricing based on the resources used is a fairer way of pricing than pricing based on outputs.

This may derive from the client's need to be reassured by a good understanding of the cost structure of the vendor. Pricing remains an area of strong distrust between clients and vendors.

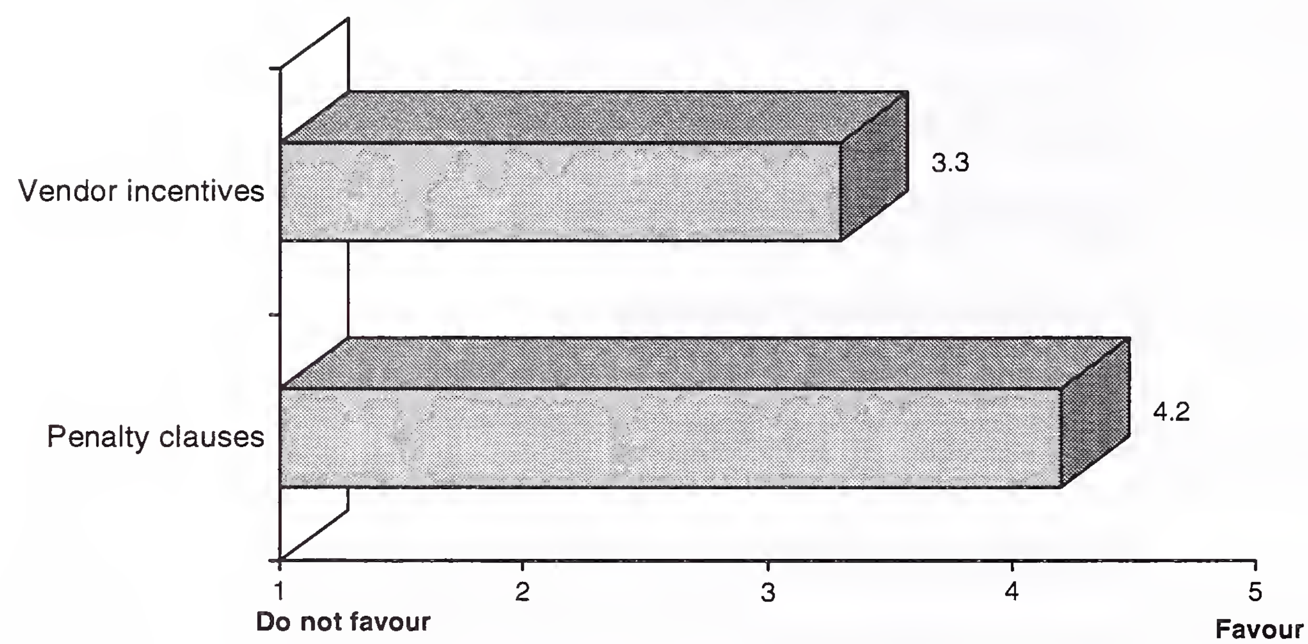
E

Clients Favour Penalty Clauses to Enforce SLA Delivery

Exhibit III-23 lists how appropriate clients perceive each of penalty clauses and vendor incentives to be in outsourcing contracts.

Exhibit III-23

Client Attitude to Penalties and Incentives



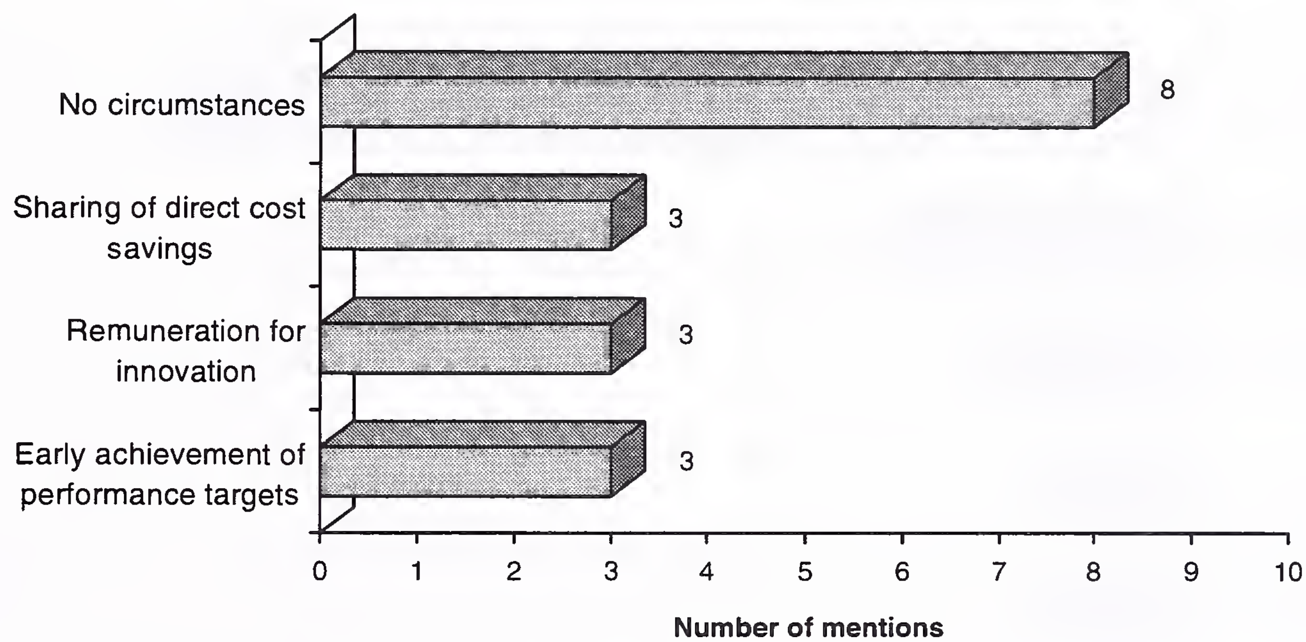
Sample of 31 respondents. Standard error = 0.2 *Source: INPUT*

Penalty clauses are typically seen to be very appropriate while many clients see incentive clauses as unnecessary.

The principal circumstances under which vendor incentives are perceived to be appropriate are listed in Exhibit III-24.

Exhibit III-24

Circumstances for Vendor Incentives



Sample of 31 respondents. *Source: INPUT*

Many clients feel quite strongly that vendor incentives are inappropriate under all circumstances. Some examples of this strength of feeling are contained in the following quotations from the survey:

If I pay some-one a fixed price I see no reason to add extra incentives.

Under no conditions. The vendor should give us incentives.

Renewal of the contract is the vendor's incentive.

Doing business with them should be enough incentive really.

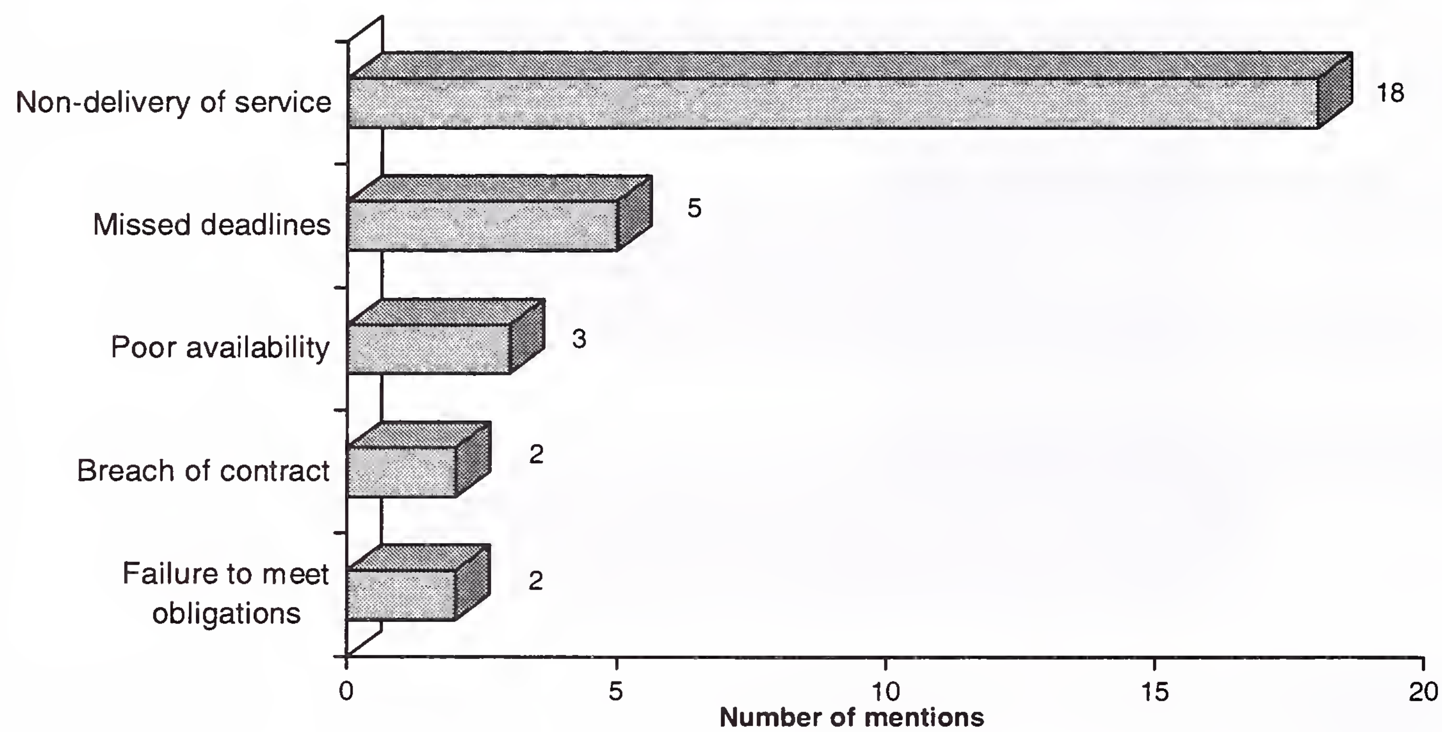
On the other hand, other clients are prepared to share any savings achieved through innovation or superior performance by the vendor. Many of these savings relate to more efficient use of IT infrastructure but underbudget project delivery was also mentioned as an area where the savings could be shared between client and vendor.

In one case, the client was prepared to share the business benefits accruing from early delivery of new systems/applications.

The principal circumstances under which vendor penalties are perceived to be appropriate are listed in Exhibit III-25.

Exhibit III-25

Circumstances for Vendor Penalties



Sample of 31 respondents.

Source: INPUT

Twenty-seven out of the thirty-one respondents strongly perceive that penalty clauses are appropriate in outsourcing contracts.

The majority of clients are concerned about the vendor failing to meet the contracted service levels. Typical comments from respondents included:

Rebate if services not provided in line with agreement

Failure to achieve agreed level of service. Penalty should be related to effect on the business and proportioned to the contract cost.

Failure to meet SLAs/deadlines. It should be linked to the impact on the business in terms of the number of users affected.

If the level of performance to which the vendor has agreed in the contract is not met over a long period of time

This attitude is exemplified by the following case study.

This organisation receives mainframe operations and application management services from a single vendor. The contract is 80% fixed price with variable cost elements for application development and enhancements.

1. Nature of the Contract

The 80% fixed cost element covers mainframe operations and software support. The vendor also purchases desktop equipment and re-leases it to the client to lengthen the depreciation period.

The contract also includes a number of *low-cost* man-hours for application developments, enhancements and maintenance. Once this allowance is exhausted, the price of man-hours is related to the type of work and the notice period given.

The contract contains financial performance penalties.

The pricing is not strongly linked to service levels and the client regards these service levels as *bolted on* to the contract. The contract is also engineered to avoid disputes when a problem occurs.

The contract is of 5 years duration with a three year opt-out option. Pricing reviews are to be held annually.

2. Pricing Mechanism: Likes and Dislikes

The client likes the fact that the fixed price arrangement gives certainty of budgeting. The SLAs are also perceived to be comprehensive with significant penalty points.

The client's main criticisms of the pricing mechanisms used are the level of overhead incurred in their management. According to the client, "you can't just outsource and forget about it". The SLAs took a long time to produce and you still have to watch and validate the billing.

In addition, the client perceived a hidden cost in extra user group meetings, since "you have to have meetings before anything can be done."

The organisation is also currently assessing outsourcing of desktop services and the respondent was "shocked at the variances between tenders" on the basis of price per user. This situation is creating some distrust of vendors and undermining their credibility in pricing such services.

3. Proposed Changes to Pricing Mechanism

Overall this client is less than totally satisfied with vendor performance so far and their current attitude can be summarised in the following remark, "I think we picked the best of a bad bunch."

This attitude has a significant impact on their attitude towards modification of the pricing mechanism.

The client would principally like to change the pricing mechanism in two ways:

- Firstly by implementing a more detailed and accountable billing mechanism

- Secondly by greatly increasing the financial penalties for the vendor in the event of inadequate performance.

There have apparently been a substantial number of failures to meet the target SLAs. However from the perspective of this client, the current levels of compensation are perceived to be "not worth the paperwork. If it doesn't hurt the vendor, it's not worth having."

The client would like to use financial penalties to cure apparent problems with the vendor's attitude to the client. The client claims to have recently informed the vendor that response times had increased by 50%. Besides the obvious performance failures, this annoyed the client because:

- They felt that the vendor should have been the one to inform the client of this situation

- They felt that the vendor should accept the criticism, "but they don't".

As a result, this client now favours fixed price contracts with severe penalties and would, emotionally at least, like to increase the value of the financial penalties tenfold.

The client perceives that each of the following items should be covered by penalty clauses:

- Critical deliverables and the quality of these

- Availability of services

- Network up-time

- Response times.

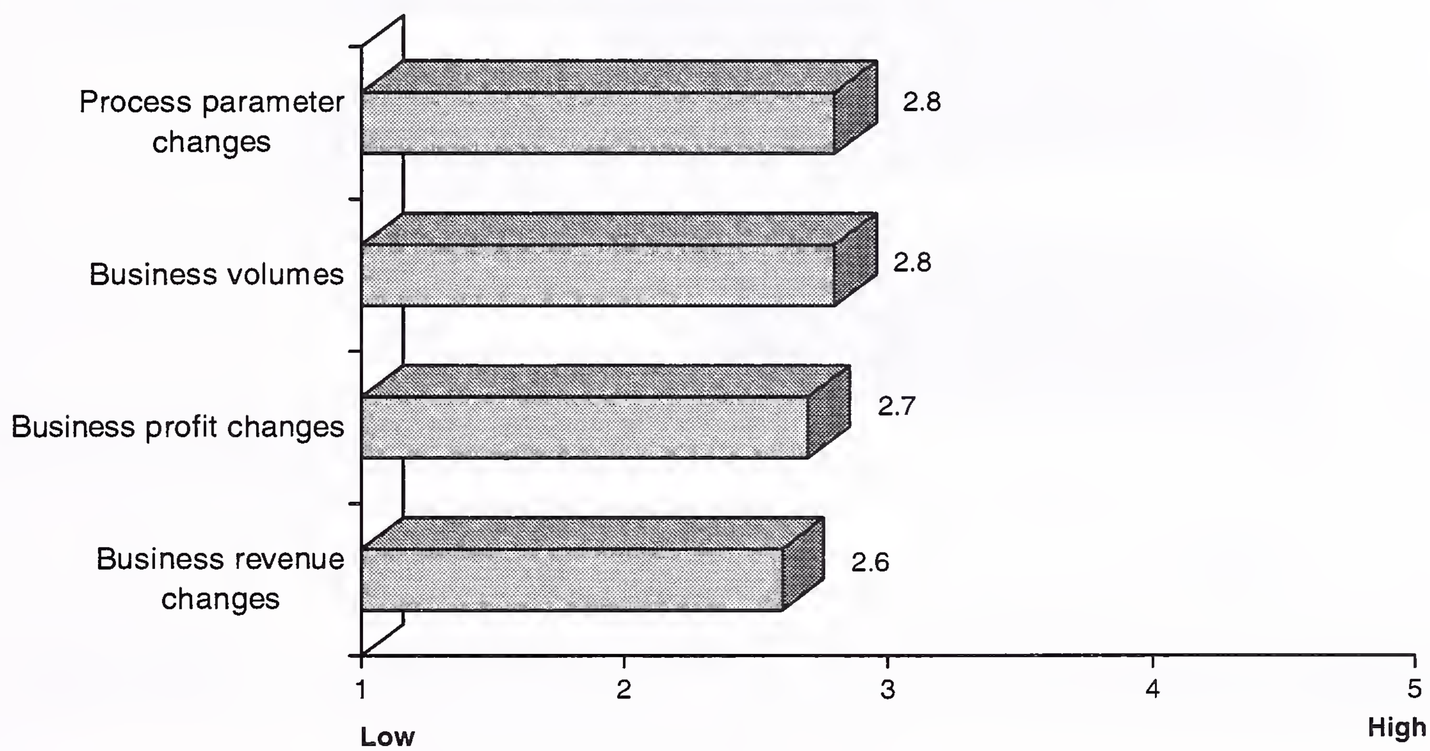
F

Clients Have Difficulty in Assessing Vendor Business Process Improvement Capability

It is widely recognised as being difficult to find a suitable basis for value-based contracts. Within this study clients were asked to rate the suitability of each of a number of parameters as bases for value-based outsourcing arrangements. The results are listed in Exhibit III-26.

Exhibit III-26

Suitability as Basis for Value-Based Pricing



Sample of 26 respondents. Standard error = 0.2 *Source: INPUT*

No clear picture emerged. However it is likely that calculations based on improvements to a particular process will prove more successful than generalised links to business revenues or profitability. Depending on the particular initiative, examples of suitable process parameters might include:

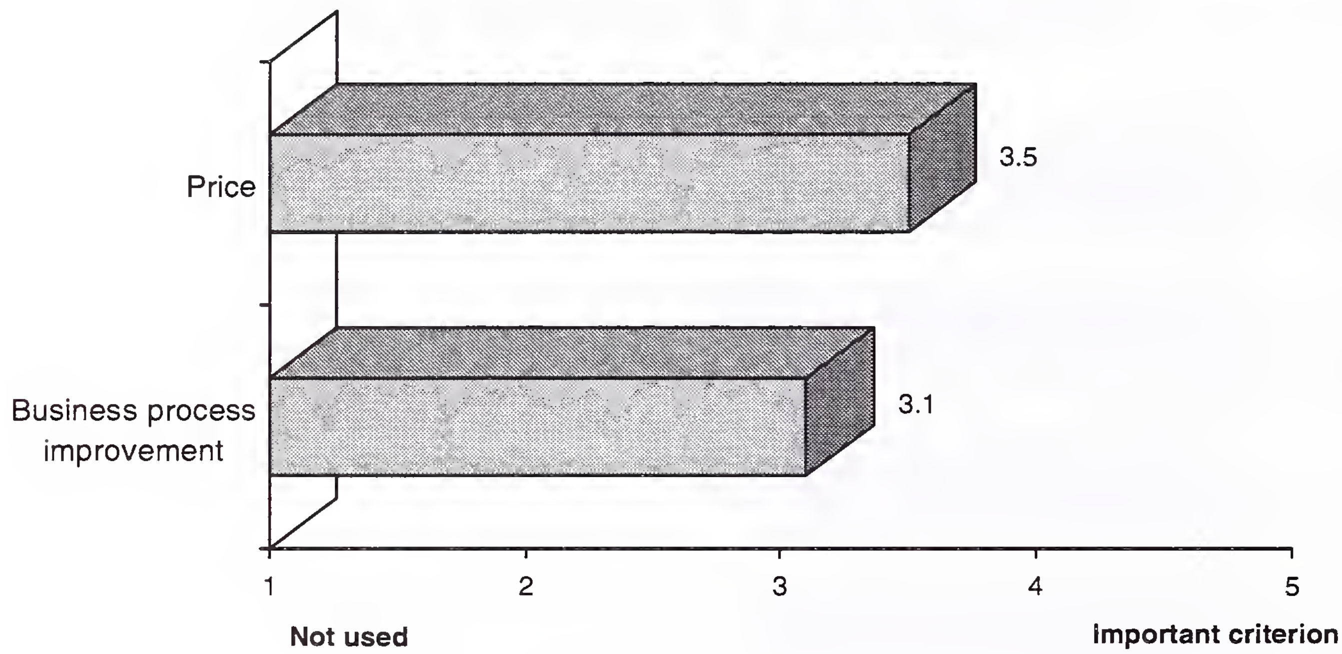
- Reduction in time to market
- Improved inventory turnover
- Proportion of revenues collected within a specified time frame
- Increases in the client's customer satisfaction measures

- Similarly it should be possible to link certain types of contract, particularly business operations contracts, to business volumes such as the number of cheques processed.

Exhibit III-27 shows the relative importance of contract price and business process improvement considerations in the selection of the current outsourcing vendor.

Exhibit III-27

Previous Vendor Selection Criteria



Sample of 30 respondents. Standard error = 0.2 *Source: INPUT*

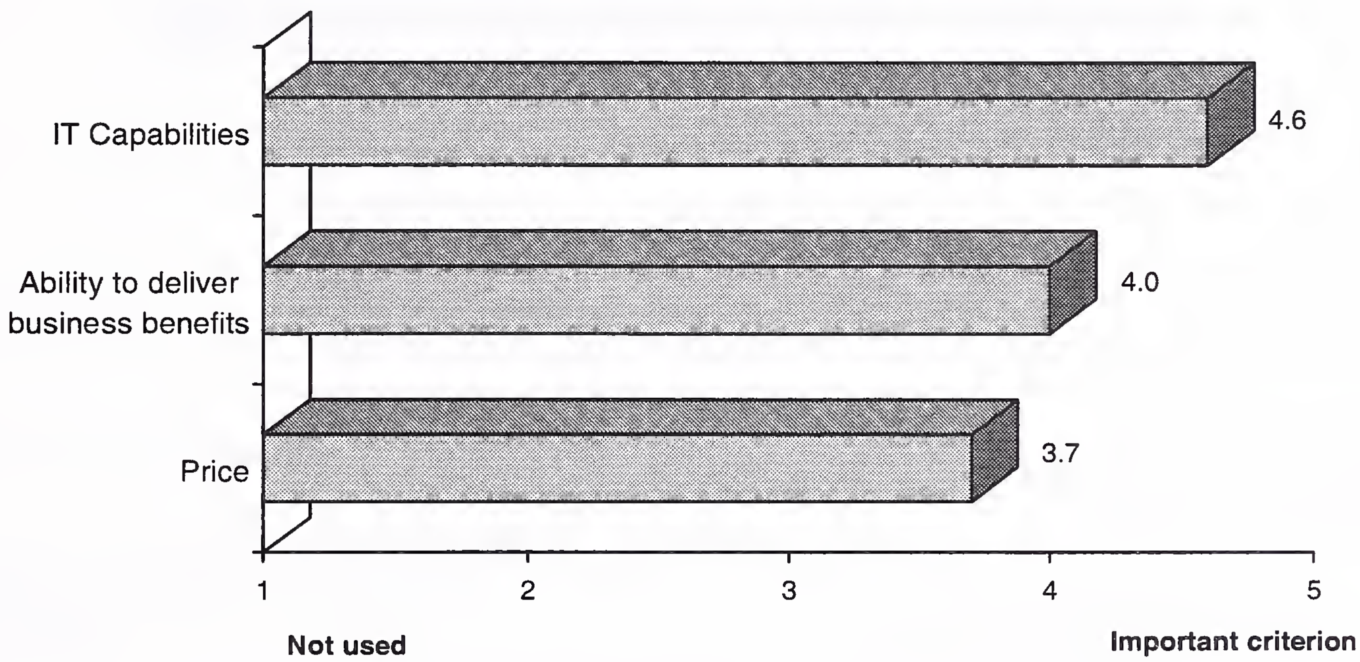
However, this does not necessarily mean that business process improvement is relatively unimportant to the client. Instead it is possible that this situation has arisen because of the difficulty of assessing and differentiating between vendors on the basis of their relative business improvement capabilities.

Outsourcing clients were also asked to what extent it is possible to distinguish between outsourcing vendors in terms of their ability to deliver business process improvement. Only a quarter of respondents were confident of being able to distinguish between vendors in this way while 50% of clients expressed low levels of confidence in this respect.

Exhibit III-28 lists the extent to which respondents felt they would judge outsourcing vendors in future against three nominated criteria.

Exhibit III-28

Future Assessment Criteria for Outsourcing Vendors



Sample of 30 respondents. Standard error = 0.2 *Source: INPUT*

Respondents perceive that in future they will judge outsourcing vendors primarily on their IT capabilities followed by their perceived ability to deliver business benefits. However, it is unclear how clients will improve their capability to assess vendor ability in areas such as the delivery of business process improvements.

If this expectation is met, then it may lead to an increased acceptance of value-based pricing mechanisms that establish rewards for improvement in specific business process metrics. However it is likely that these value-based pricing mechanisms will be tightly linked to individual process improvements rather than to generalised measures such as increases in company revenues or profitability.

IV

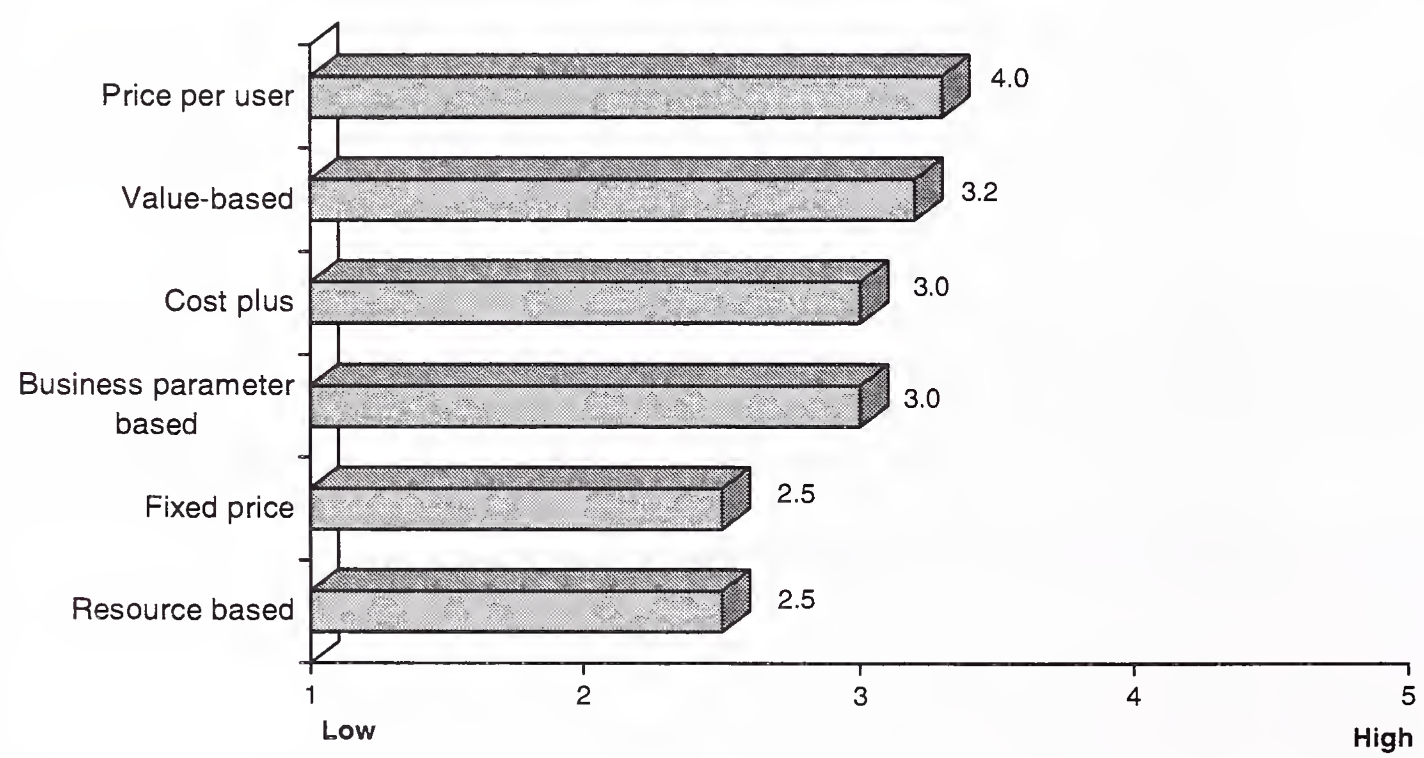
Vendor Attitudes to Pricing Mechanisms

A
Vendors Move Towards Value-Based Pricing

Exhibit IV-1 lists the extent to which vendors bid using each of a range of pricing mechanisms.

Exhibit IV-1

Vendor Usage of Pricing Mechanisms



Sample of 7 respondents. *Source: INPUT*

Vendors typically perceive themselves to be very flexible in their approach to pricing outsourcing contracts. Most vendors state that they would take the lead on pricing approach from the client and, in line with this philosophy, the majority claim not to have a preferred approach to pricing policy.

However, despite these statements, vendors seem to exhibit a preference for value-based contracts and to be trying to move away from traditional fixed price contracts. One vendor, in particular, appeared to be endeavouring to move away from pricing criteria emphasising IT service delivery in favour of increasing its identification with business benefits.

The result of this change of emphasis from the vendors is that the vendor ranking by type of pricing mechanism is roughly the reverse of the ranking of pricing mechanisms by user preference.

Vendors' attitudes to the suitability of pricing mechanism by contract type are listed in Exhibit IV-2.

Exhibit IV-2

Vendor Attitudes to Pricing Mechanisms

Service Component	Preferred Pricing Approach
Data centre management	The majority prefer fixed price, though a transaction based approach is used in some instances
Desktop services	A complete mixture of pricing mechanisms The most likely approach is price per user. However this may be combined with a cost plus or fixed price element to cover fixed costs such as on-site support personnel
Application management	Time and materials is the most likely approach, though there is some movement to shared risk/reward pricing in this area

Source: INPUT

Vendor perceptions of the advantages and disadvantages of the principal pricing mechanisms are listed in Exhibit IV-3.

Exhibit IV-3

Perceived Advantages & Disadvantages of Pricing Mechanisms

Pricing Mechanism	Advantages	Disadvantages
Fixed price	Predictability Low revenue risk Appropriate for contracts with static requirement appropriate for contracts with high element of fixed cost	Can stifle entrepreneurship & innovation Tends to create customer /supplier relationship rather than partnership Requires detailed work up-front to avoid disputes later No guarantee of value for money
Cost Plus	No risk to supplier Use in very competitive situations	Leads to intense price competition between suppliers
Variable (resource) pricing	Brings out supplier innovation	Relying on customer correctly specifying requirements Can be high risk
Transaction based / Output related	Good for cost reduction and phasing out operations Easy to manage Simple for client to measure/understand	Have to set minimum threshold
Value-based	Emphasis on partnership rather than commodity broking	

Source: INPUT

The majority of the vendors interviewed expect pricing mechanisms within outsourcing contracts to become more value-based in the future.

Other views expressed include:

- More detailed pricing mechanisms
- More output-oriented pricing
- Increasing move to function point analysis.

A contrary view was that pricing mechanisms will polarise based on the level of certainty in the requirement, with vendors offering fixed prices where there is a high level of certainty. In particular, one vendor expressed the opinion that:

- There would be a shift from cost plus and time and materials pricing mechanisms towards fixed price in situations with high levels of certainty

- A shift towards value-based, shared risk and reward pricing mechanisms where there are high levels of uncertainty in the customer requirement.

This latter view fits well with the trend to link pricing to achievement for business process related contracts. Within this framework, a large part of an outsourcing framework could consist of fixed price contracts for well-defined - typically infrastructure management - activities. Alongside this, there could be a number of value-based contracts concerned with individual business improvement initiatives, such as a reduction in time to market, or a reduction in stockholding.

The difficulty with value-based contracts is the difficulty in finding a metric or metrics that can be sufficiently clearly linked to the effectiveness of individual information systems.

Typically measures such as changes in organisation revenues and profitability are too broad to be useful measures for risk/reward pricing. Vendors do not wish to take risks with major portions of revenue where many of the factors are outside their control. Similarly many organisations would feel that IT was only a minor contributor to any increase in organisation revenues and so the vendor should not be rewarded to a much greater extent than they had contributed.

The answer seems to lie in restricting any risk/reward pricing to individual initiatives, with the success or failure of each of these initiatives measured against a limited and highly specific set of metrics.

In these instances the bulk of the IT services are provided on a fixed price (including fixed price per user) basis against well-defined service level agreements.

Individual initiatives could even be carried out on a Private Finance Initiative (PFI) style basis. The PFI approach is now being widely adopted in the U.K. public sector. One of the main objectives of PFI is to encourage vendors to adopt more innovative and pro-active approaches than might have been adopted under the market testing regime whose emphasis was primarily on cost reduction of existing services. The U.K. Government, like the private sector, has now realised that the effectiveness of the solution provided is potentially more important than the achievement of minor cost reductions.

B

PFI Style Pricing Will Transfer to the Private Sector

PFI encourages vendors to adopt a much more innovative approach and encourages vendors to work more closely in partnership with their clients. In particular, it:

- Transfers responsibility for fitness for purpose to the vendor and endeavours to provide incentives for vendors to refresh the technology and solution adopted

- Encourages creative pricing

- Will lead to an increase in contract scope and length including an increase in business operations contracts.

1. Transfers Responsibility for Fitness for Purpose to the Vendor

The CCTA believe that the era of large scale market testing in U.K. central government is coming to a close and that there will be few major market testing exercises after the present group of tests involving, for example, the Health and Safety Executive and the NHS in Scotland.

In addition to its impact on market testing, contracts initiated within the Private Finance Initiative will tend to replace major systems integration projects in the public sector. The Treasury in the U.K. has stated that no new capital expenditure will be authorised unless the PFI route has been rigorously examined and shown to be inapplicable. Nor can existing departmental capital budgets be expected to remain intact.

Market testing was intended to improve value for money in purchasing services or projects on a like for like basis. However, the objectives of PFI are much wider and include:

- Obtaining value for money

- Transferring service risks to the private sector.

Central government procurement has traditionally relied on very detailed initial specifications to ensure fitness for purpose. However, these specifications have often had the opposite effect.

The PFI approach reverses this philosophy. The vendor is provided with only high level output specifications and is expected to take full responsibility for fitness for purpose.

Within PFI, vendors will be expected to fund the initial capital outlay and to recover their costs on the basis of a service charge for ongoing service provision. For example, in the first major PFI IT contract, under which Andersen Consulting has committed to develop the new National Insurance Recording System (NIRS 2) by April 1997, Andersen Consulting will receive no payments for systems development. The bulk of their revenues will be derived from the ongoing provision of a service based on this system.

This overcomes, from the government perspective, one of the key risks in undertaking major systems development projects, namely fitness for purpose. If the NIRS 2 system does not function adequately, then the government will bear neither the cost of enhancement nor the capital expenditure incurred in building a sub-standard system. These risks, which have historically been very substantial, are effectively transferred to the vendor.

The U.K. health sector, in particular, has experienced considerable difficulty in successfully applying information technology over the past decade. The PFI approach potentially enables Hospital Trusts to transfer the risk in achieving fitness for purpose to the private sector.

The first PFI project in the health service has already been contracted with Crawley and Horsham. Many more PFI projects in the health sector are under consideration, though only a small number of these involve IT. However, it is now mandatory that the PFI approach is tested for all capital expenditure requests within the NHS. At the moment, all capital requests from the NHS that do not evaluate a PFI-based solution are being declined by the Treasury, with a request that PFI be considered as an alternative approach. Only when PFI has been shown to be inapplicable to an individual case will alternative funding mechanisms be considered.

Although this has led to short term restrictions, the Private Finance Panel believes that this approach will ultimately increase the level of development in the NHS.

2. Encourages Creative Pricing Mechanisms

Within NIRS 2, the Private Finance Panel expects to achieve a 60% saving compared to the costs of building and running the system within the public sector. Typically, the Private Finance Panel expects to achieve 30-35% savings in the initial PFI contracts, settling down to 20-25% over time.

Through PFI, the government expects to achieve annual savings of approximately $3 billion per annum, approximately half of which will be re-invested in new contracts.

PFI adopts innovative pricing mechanisms and it also encourages creative pricing proposals from vendors.

PFI pricing can be based on three components:

- A service development component
- An operational service component
- A transfer payment.

In practice, the government prefers the vendor not to charge for system development but to recoup its costs on the basis of ongoing service charges. In those cases where the client does fund development activity, then the vendor is expected to provide a maximum price. In addition, a system of bonus payments will be used to provide incentives for the vendor to remain significantly below this ceiling.

The operational service provision will typically be priced on the basis of a volume related payment. Again, the vendor is expected to share some of the risk in the level of system usage.

For example, in the case of NIRS 2, service payments are based on 15 key transactions. However, the risk inherent in the actual volume of transactions is shared between vendor and client. In this case, payments based on a throughput of 70% of this volume are guaranteed to Andersen Consulting. However, the cost to the government is capped at approximately 125% of the estimated volume of transactions regardless of whether or not this level is exceeded.

Typically the Private Finance Panel expects to guarantee vendors 70% of the anticipated service payments, provided that the service is available and functioning appropriately.

In many instances, it will be difficult to establish the precise usage of a service in advance. In these cases, an overall price will be established and the service charge calibrated from this on the basis of usage in the first three months of service operation.

The final payment element is related to contract renewal. Four options are possible at contract renewal:

- The original vendor could win the renewal

- A new vendor could win the service contract using the systems developed by the original vendor

- A new vendor could win the service contract with a proposal based on new systems

- The administrative function that the service supports could have changed dramatically or be no longer required.

The option of a new vendor winning the contract whilst retaining the original vendor's systems is designed to prevent vendors from taking advantage of barriers to entry derived from their initial systems development or over-recovering their initial costs through service operation charges.

The Private Finance Panel believes that appropriate updating of service delivery technologies throughout the life of the contract will assist the vendor in ongoing service cost reduction resulting in lower charges to the government and improved margins for vendors. However, the government also wishes to incentivise vendors to refresh the technology and systems on which their service is based. These financial incentives are based on two elements:

- The first is a transfer payment to the original vendor, paid by the successful bidder, should they lose the contract renewal, but their solution remain the basis for the successful vendor's ongoing service provision

- The second is the absence of any transfer payment should a new vendor be successful with a new service proposal based on a new solution.

The size of the proposed transfer payment is dependent on the nature of the service being provided and its underlying technology. The transfer payment quoted is under the control of the vendor making the bid and the proportions quoted will vary considerably even within the same service opportunity.

So far, transfer payments of 10% and 25% have been quoted by vendors. At this stage, the Private Finance Panel expects transfer payments to typically fall in the range zero to 50%. The Private Finance Panel favours high transfer values, perceiving transfer values to be an expression of the vendor's confidence in their solution and their willingness to refresh applications and technology as necessary during the life of the contract.

In theory, transfer prices could be based on a combination of equipment, personnel and applications. However, in practice, the Private Finance Panel expects the application to account for the bulk of any transfer price. Any hardware is expected to be largely obsolete by the end of the contract, though periodic equipment refreshment could change this assumption.

Finally, should the application no longer be relevant because of, for example, legislative changes, then the government department will re-imburse the vendor with the transfer payment.

The pricing mechanisms described above are a standard feature of PFI. In addition, the Private Finance Panel would like vendors to propose innovative risk sharing mechanisms of their own. In particular, the Private Finance Panel would like to see vendors developing revenue streams for their services from outside the public sector. For example, it is envisaged that a vendor developing and running systems for the public records office could base their total revenue recovery on selling services direct to non-governmental bodies. As a result, in this example, the government could meet its own aims at zero cost.

However, this approach means that successful vendors will need access to large amounts of capital, either internally or through collaboration with a financial institution, and must be able to sustain projects with a considerable negative cash flow in their early stages. Stage payments for development are not likely to be a successful approach in this new market.

The NIRS2 model is regarded as a relatively simple form of pricing where there is a need to provide the service quickly and where the volume of transactions can be accurately estimated in advance. Other models include one applicable to the NHS and a catalogue approach to supplying users with a range of application software products.

3. Leads to Increase in Business Operations Contracts

The philosophy adopted within PFI ensures that vendor creativity will be rewarded. It also encourages vendors to develop proposals that extend beyond IT. In the example suggested above, the most acceptable proposal for developing and running the IT systems within the public records office is likely to be one that involves the vendor taking responsibility for marketing the business operation and manning the customer interface not just providing IT services.

This trend towards business operations services has already become widely adopted within the U.K. local government community. It appears that much of the thinking behind the concept of the *enabling authority* is now being transferred beyond local authorities to other public sector bodies such as central government departments and the health sector.

For example, the PFI approach is now being considered for clerical functions within the Immigration Department, and it is probable that the entire DSS Occupational Pensions Regulatory Authority will be outsourced under PFI. This approach may also be adopted within the DSS Benefits Agency provided that demarcation lines between adjudication and clerical functions can be established to leave adjudication as the responsibility of civil servants.

So far, PFI has yet to be applied to local government, but it is likely that this approach will be increasingly applied here also. The result will be an increase in managed service outsourcing and a decline in purely IT-related outsourcing.

So far, this style of pricing mechanism has not appeared in the private sector, but the PFI model is one that could readily be applied to non-core business processes within organisations in the private sector.

This would:

- Change organisations' outsourcing focus to business process outsourcing rather than IT outsourcing

- Imply the outsourcing of sub-sets of IT to a range of best of breed business process outsourcers rather than the outsourcing of the entire IT function to an IT outsourcing specialist.

C
Vendors Expect Bonus Payments for Exceeding Target SLAs

The majority of the vendors interviewed are looking to lengthen the span of their outsourcing contracts. The minimum length of contract that vendors sought was typically 3 years with some vendors seeking a 5 year minimum. Similarly the typical maximum length was 7 years with some vendors extending contracts to 10 years or more.

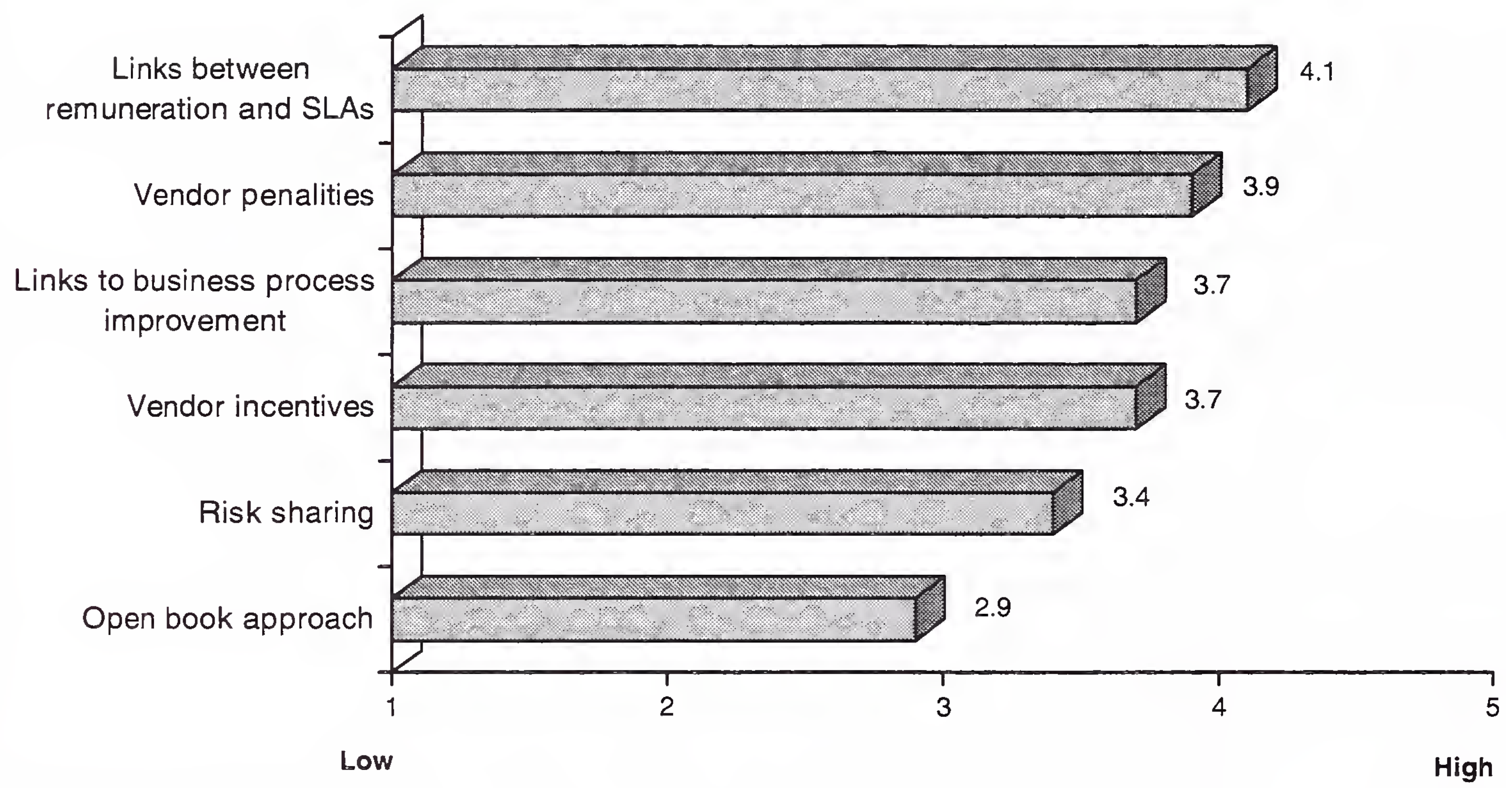
Overall the growing emphasis on value-based contracts is encouraging vendors to try and lengthen their outsourcing contracts. At present the average outsourcing contract length in Europe is 4 years, but this is likely to steadily increase over the next few years.

The timescale for review of contract pricing varies considerably from vendor to vendor and from contract to contract. Some vendors review contract pricing annually, or even monthly. Others specify agreed breakpoints in the initial contracts; while yet others appear to try and avoid pricing reviews altogether during the course of the contract.

Exhibit IV-4 summarises the extent to which vendors build a number of features into their outsourcing contracts.

Exhibit IV-4

Vendor Usage of Contract Features



Sample of 7 respondents. *Source: INPUT*

In practice, vendors tend to incorporate penalty clauses into their outsourcing contracts. However, they are relatively reluctant to do so and it may be necessary for clients to insist on these. Penalty clauses tend to be used to insure against consistent failure to meet contracted SLAs.

Vendors are more likely than users to take the view that partnership requires empathy and penalty clauses show a lack of willingness to work together.

On the other hand, vendors commonly expect to receive incentive payments in return for exceeding target SLAs. Some clients accept this situation. Others take the attitude that if they have contracted for a particular level of service then that is what they expect to have delivered, no more and no less.

Vendors are typically seeking circumstances where they can adopt value-based pricing and some vendors endeavour to present all outsourcing contracts from this perspective.

However, vendors are much less enthusiastic than users about offering an open book approach to outsourcing.

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A

User Questionnaire

Services Outsourced

1. Which of the following functions does your organisation outsource and to whom? What pricing methodology was used in the outsourcing of each of these functions? (prompt with: fixed price, price linked to resource usage, cost-plus, price per user, linked to business parameter, value-based (the vendor receives a proportion of increased revenue or savings), other. How satisfied are you with the pricing of each of these contracts?

Note to interviewer: answer could be a combination of these.

Function	Outsourced	Vendors	Pricing Methodology	Satisfaction (1-5)
Day-to-day operation of mainframe(s) and/or stand-alone mid-range equipment...(1)	Yes/No			
Day-to-day management of the personal computer infrastructure including servers and local area networks...(2)	Yes/No			
Day-to-day management of the corporate data network...(3)	Yes/No			
Support and maintenance for in-house developed applications...(4)	Yes/No			
Responsibility for new systems development as a preferred supplier...(5)	Yes/No			
Business process reengineering consultancy...(6)	Yes/No			
IT strategy consultancy...(7)	Yes/No			
Other IT consultancy services...(8)	Yes/No			
Business functions such as accounting or fulfilment...(9)	Yes/No			

2. Overall how satisfied are you with each of the following? Please rate on a 1-5 scale where 1 = not at all satisfied and 5 = very satisfied.

The pricing mechanisms currently used ______

Current pricing levels ______

Your ability to renegotiate price levels ______

Your level of savings ______

Your visibility of vendor costs ______

3. What do you like and dislike about the pricing mechanisms used within your outsourcing contracts?

____

____

____

____

4. How important, and how satisfactory, are the following aspects of your pricing mechanism? Please rate on a scale of 1-5 where 1 = unimportant/dissatisfied and 5 = very important/very satisfied.

Attribute	Importance (1-5)	Satisfaction (1-5)
Open book approach		
Sharing of risk with vendor		
Incentives to encourage vendor creativity		
Links to business parameters		
Links to business process improvement		
Links to business success		
Ability to deliver initial cost reduction		
Ability to deliver ongoing cost reduction		
Payback clauses		

5. How frequently do you review the pricing of your outsourcing contract(s) with the vendor?

____

____

6. How satisfactory is this arrangement? Please rate on a scale of 1-5 where 1 = not at all satisfactory and 5 = very satisfactory.

____

7. Have you ever initiated the renegotiation of the price of an outsourcing contract?

Yes/No

8. If so, why? What was the outcome?

____

____

9. How would you like to change the pricing approach used in your current contracts?

____

____

____

____

10. What pricing mechanisms will you seek to adopt for use in future outsourcing contracts?

____

____

____

Why?

____

____

____

11. If you had the opportunity to renegotiate the contract today, would you change the pricing approach used?

Yes/No

If so, how?

___

___

12. Do you think that the type of pricing mechanism used depends upon the activities being outsourced?

Yes/No

Which type of pricing mechanism do you believe is most appropriate for outsourcing each of the following:

Mainframe operations

Desktop services including LANs and servers

Application management (support and development

Wide area networks

Business Operations

Note to interviewer: Only ask each of questions 9-12 if the respondent has contracts of this type (see Q1).

13. How suitable do you believe each of the following pricing mechanisms to be for datacentre, or mainframe, management contracts?

Fixed price ___

Price linked to actual resource usage ___

Cost-Plus ___

Price linked to business parameter ___

Value-based ___

Price per user ___

14. How suitable do you believe each of the following pricing mechanisms to be for desktop services and LAN management contracts?

Fixed price	_______
Price linked to actual resource usage	_______
Cost-Plus	_______
Price linked to business parameter	_______
Value-based	_______
Price per user	_______

15. How suitable do you believe each of the following pricing mechanisms to be for application management contracts?

Fixed	_______
Price linked to actual resource usage	_______
Cost-Plus	_______
Price linked to business parameter	_______
Value-based	_______
Price per user	_______

16. How suitable do you believe each of the following pricing mechanisms to be for business operations contracts?

Fixed price	_______
Price linked to actual resource usage	_______
Cost-Plus	_______
Price linked to business parameter	_______
Value-based	_______
Price per user	_______

17. How appropriate do you believe are penalty clauses and vendor incentives in outsourcing contracts? Please rate on a scale of 1-5 where 1=not at all appropriate and 5=very appropriate.

Penalty clauses ______

Vendor incentives ______

18. Under what conditions do you think that vendor incentives such as value-based pricing are appropriate? What sort of incentive do you think is appropriate?

____

____

____

19. How appropriate are each of the following parameters as a basis for value-based pricing arrangements?

Business volumes ______

Business revenue changes ______

Business profit changes ______

Process parameter changes ______

Note to interviewer: Process parameters could include for example, time to process customer enquiry or sale, stock-turn, etc.

What other bases would you suggest?

____

____

____

20. What possibilities do you think should be covered by penalty clauses containing financial penalties or paybacks?

____

____

____

21. How important was price in your final selection of the vendor? Please rate on a scale of 1-5 where 1=not at all important and 5=the dominant factor.

_____

22. How important was business process improvement in your final selection of the vendor? Please rate on a scale of 1-5 where 1=not at all important and 5=the dominant factor.

_____

23. To what extent do you believe it is possible to distinguish between outsourcing vendors in terms of their ability to deliver business process improvement? Please rate on a scale of 1-5 where 1=very difficult and 5=very easy.

_____

24. To what extent, will you attempt to judge outsourcing vendors in future on each of the following: (Please rate on a scale of 1-5 where 1=not at all and 5=very strongly.)

Their IT capabilities _____

Their price _____

Their ability to deliver business benefits _____

25. How much influence did your organisation have as a client in influencing the pricing approach(es) used? Please rate on a scale of 1-5 where 1 = none and 5 = major influence.

_____

26. To what extent do you believe that the client should influence the choice of pricing approach? Please rate on a scale of 1-5 where 1 = none and 5 = major influence.

____

27. Did you have a benchmark of how much outsourcing should cost before talking with a vendor?

Yes/No

What was it based on?

____

____

____

28. What financial techniques do you use to judge the cost-effectiveness of outsourcing contracts?

____

____

____

29. Do you actively monitor the prices of other vendors or organisations using outsourcing?

Yes/No

If so, how?

____

____

____

Thank you very much for your assistance

(Blank)

B

Vendor Questionnaire

1. What bases do you use for pricing outsourcing contracts?

2. Which do you prefer? Why?

3. How has your approach to pricing of outsourcing contracts changed over the past year? Why?

4. How extensively do you bid using each of the following contract types?

Pricing Mechanism	Degree of usage (1=low 5=high)
Fixed price	
Price linked to actual resource usage	
Cost plus	
Price linked to business parameter	
Price per user	
Value-based (i.e. revenue or profit sharing)	

5. Which of the following outsourcing service types does your company offer? Which pricing mechanisms do you believe are most appropriate for each of the following contract types?

Platform Operations/Datacentre management offered: Yes/No

Principal pricing mechanism used

Desktop Services/Distributed systems management Offered: Yes/No

Principal pricing mechanism used

Application management Offered: Yes/No

Principal pricing mechanism used

Combined applications operations Offered: Yes/No

Principal pricing mechanism used

Business operations Offered: Yes/No

Principal pricing mechanism used

6. What do you see as the advantages and disadvantages of each of the main types of outsourcing pricing mechanism?

____

____

7. How is your usage of pricing mechanisms likely to change in the future? Why?

____

____

____

8. What length of outsourcing contract do you typically aim for?

____

9. How regularly do you review each of the following with your outsourcing clients?

Pricing mechanism ______

Contract Pricing ______

10. How extensively do you use each of the following within outsourcing contracts? Please rate on a scale of 1-5 where 1=very rarely and 5=very frequently.

Open book approach ______

Vendor penalties ______

Vendor incentives ______

Risk sharing ______

Links between remuneration and SLAs ______

Links to business process improvement ______

11. Under what circumstance would you introduce each of the following:

Vendor penalties ______

Vendor incentives ______

Value-based pricing ______

12. What financial techniques do you use to assist you in setting contract prices?

____

____

____

Thank you very much for your assistance.