Output- and Outcome-Based Service Delivery and Commercial Models

To extract more from IT sourcing arrangements, buyers and best-in-class providers must embrace value-based models that prioritize measurable and meaningful results over human resource-oriented inputs.
Executive Summary

It takes a delicate balance to set up a sourcing partnership that is mutually beneficial to buyers and providers of IT services. Lasting win-win partnerships flourish only when both sides are satisfied: Buyers see consistently strong results from their investments that positively influence business outcomes, and providers are empowered with a sense of ownership and incentivized to think big, innovate and outperform in their own right.

For far too long, buyers and providers have engaged in traditional sourcing models that are safe but suboptimal (e.g., arrangements based on staff augmentation and commercial constructs, such as time and materials or fixed-capacity service delivery). Historically, buyers approached sourcing as a way to access the right skills at the right price at the right time, without exploring the possibilities that lie beneath the surface. Meanwhile, providers have tended to play it safe by sticking to manpower-linked linear growth models that, though predictable, do not necessarily maximize value.

This deep-seated reluctance to change prevalent sourcing models has resulted in several significant drawbacks for both buyers and sellers of IT services. Buyers are generally unable to link the benefits of procuring IT services from third-party providers to the realization of business objectives and pay for results delivered. And providers command limited ownership, accountability and “mindshare,” relegating them to the role of vendor, not trusted partner.

However, all this is changing. A new breed of “next-generation” buyers and “best-in-class” providers is now emerging and vigorously challenging the status quo. Many of these players are seeking sourcing arrangements that align buyer and provider incentives and foster collaborative co-creation. Riding this wave, managed services agreements using output- and outcome-based commercial pricing constructs are gaining traction as the sourcing paradigm of the future.

This whitepaper explores different variants of this model, their relative merits and limitations, situations suitable for their adoption and how they can and should be governed. We conclude with a case study illustrating how one IT organization has broken the mold by adopting such models on a large scale through multi-year contracts with its providers.
Defining Input, Output and Outcome: Three Important Sourcing Terms

At the outset, it is important to understand three terms related to sourcing that recur in most sourcing exercises: input, output and outcome (see Figure 1).

- **Outcomes are measurable impacts delivered by providers of IT services that can be assessed objectively by services buyers.** This could include business outcomes, such as improvement in the enrollment rate of a healthcare plan, or IT outcomes, such as reduced spending on quality assurance as a percentage of the IT budget.

- **Output represents activities that are undertaken to realize desired outcomes.** This could also involve business outputs, such as healthcare policy quote generation or enrollment processing, and IT outputs, such as test case creation and execution.

- **Inputs are the resources used to deliver the required output.** Examples of inputs include available full-time equivalents (FTEs), funds, time, equipment, etc. Ideally, all inputs needed by an IT organization should be traceable through the outputs they deliver and the outcomes that customers and businesses ultimately value.

Defining Service Delivery and Commercial Models

There are two basic aspects of any sourcing arrangement between the buyer of an IT service and the provider: the service delivery model and the commercial model.

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**Where Input, Output and Outcome Align**

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[Figure 1]

- **Outcomes are measurable impacts delivered by IT services providers that can be assessed objectively by buyers of these services:**
  - Business outcome examples: Improved enrollment rate of a healthcare plan, increased collection of outstanding receivables, improved net promoter score, etc.
  - IT outcome examples: Reduced spend on quality assurance as a percentage of the IT budget.

- **Outputs are measurable, discrete units of work undertaken to realize the desired outcomes:**
  - Business output examples: Policy quote generation, claims processing, invoice generation, reconciliation transactions, etc.
  - IT output examples: Test case execution, incident resolution, etc.

- **Inputs are the resources used to deliver outputs.**
  - Examples include FTEs sourced from a service provider, capacity procured, etc.
The service delivery model refers to the terms of engagement between the buyer and provider of IT services. Typical terms of engagement include determining who owns which aspects of delivery across the IT value chain, the exact division of roles and responsibilities, and who makes the resourcing decisions (e.g., resource mix, location, etc.). Service delivery models can be broadly classified in two categories (see Figure 2):

- **Traditional models**, in which the buyer of IT services owns service delivery and manages it on a day-to-day basis. In these models, the buyer procures inputs (person hours, capacity, etc.) or components of output from the external service provider. Examples include staff augmentation (in which the buyer procures person hours from the provider) and co-sourced delivery (in which the buyer procures components of the overall output or project deliverables).

- **Emerging models**, in which the provider assumes overall IT delivery responsibilities and is accountable for delivering pre-defined outputs or outcomes. Examples include managed services arrangements, in which the service provider ideally takes end-to-end ownership of people, process and technology and is accountable for delivering IT or business outputs and/or outcomes.

The commercial model refers to the contractual agreement that specifies how services rendered by the provider are priced or charged back to the buyer. Commercial models broadly belong to three categories (see Figure 3, next page):

- **Input- or headcount-based models**, in which pricing is directly and linearly linked to headcount. Time and materials, fixed capacity and any combination of the above reside in this category.

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**Classifying Service Delivery Models**

![Service Delivery Model Diagram](figure2.png)
Classifying Commercial Models

- **Output- and non-headcount-based models**, in which pricing is directly linked to discrete units of output delivered by the provider (e.g., transactions, requirement or function points, test cases, etc.) or units of consumption from the perspective of the buyer (e.g., per ticket raised, per application used, per device used, etc.).

- **Outcome- and non-headcount-based models**, in which pricing is based on the measurable cost or revenue impact delivered by the provider to the buyer (e.g., pay proportionate to performance, gain share model, etc.).

The above classification scheme is not mutually exclusive. Although they are relatively less prevalent, hybrid models that combine elements of these models are not unheard of. Input- or headcount-based models can be viewed as traditional commercial models, while output- and non-headcount-based models and outcome- and non-headcount-based models can be treated as “alternate” models.

**The Changing Sourcing Landscape**

A large majority of IT services buyers across industries already engage providers in traditional service delivery arrangements (staff augmentation, co-sourced delivery, etc.) and use traditional commercial models to price contracts (time and materials, fixed capacity, etc.). Although these models can be simple to understand and implement, they have several shortcomings, from the perspective of both the buyer of IT services as well as the provider.

Key shortcomings of these models from the buyer’s perspective include:

- IT delivery-related risks remain entirely with the buyer.
- Provider performance is not measured based on business need or impact delivered.
The absence of effective mechanisms (e.g., price per unit of requirement or testing) makes it difficult to compare the efficiency or effectiveness of various providers.

Key shortcomings of these models from the IT provider’s perspective include:

- Providers lack the necessary ownership across the IT value chain to proactively undertake optimization and improvement.
- There is no incentive to push the envelope beyond manpower-linked linear growth, leading to declining profitability over time as costs increase.
- The levers for differentiating among competing providers are limited to reducing costs through more effective labor arbitrage, better performance on service level agreements (SLAs), etc.

As enterprises across industries confront greater global economic uncertainty, changing market dynamics and disruptive technology (e.g., social media, mobile, analytics and the cloud, or the SMAC Stack™), buyers of IT services are increasingly looking to enter into sourcing arrangements with service providers that are predicated on the ability to obtain predictable and measurable results. Businesses are no longer willing to let providers operate merely as suppliers of input.

On the other hand, providers — which have historically been content to operate through traditional input- and headcount-based models that allow them to tap into relative wage differentials across geographies to build a strong value proposition — are increasingly realizing that such approaches are ill-equipped to deliver predictable outputs and outcomes. They seek more control over delivery across the IT value chain.

**The Sourcing Paradigm of the Future:**

**Two Noteworthy Trends**

So, where is IT sourcing headed? What is the definitive sourcing paradigm of the future? According to interviews with IT leaders, a study of industry trends and an evaluation of analyst recommendations, significant secular shifts are reshaping the sourcing landscape. Two prominent trends include:

- **Trend #1: Managed services-based service delivery arrangements are gaining prominence.** Old value propositions of labor arbitrage, scale benefits and access to skills have become tablestakes, and traditional service delivery models are becoming less attractive to clients. In fact, in our experience, a majority of the IT organizations (more than 50%) with whom we interact say they are planning to increase the use of managed services. In response, many IT services providers are investing in new managed services offerings.

- **Trend #2: Non-headcount-based commercial models are gaining traction.** Headcount-dependent, input-based models are the most prevalent commercial arrangement today. However, this is slowly changing as more mature clients explore “alternate” options in which commercials are decoupled from headcount. According to some estimates, only 5% of business is conducted through non-headcount-based commercial models today, but this is likely to increase to 10% to 15% in the next two to three years.

Market observers, analysts and intermediaries with considerable sway over the purchase decisions of IT organizations are also advising buyers to favor providers that can take end-to-end ownership of IT delivery, whether processes, resources or, in some cases, platform services. Advisors also recommend choosing providers
that can deliver agreed-upon output and outcomes in a managed services mode and, over time, move to non-headcount-based commercial constructs that link price with value.

We believe that traditional service delivery and commercial models that constitute the bulk of current business will make way over time for managed services that use alternate output- and outcome-based commercial models. Such arrangements will be the sourcing paradigm of the future (see Figure 4).

**Best-Fit Commercial Model Options for Different Sourcing Scenarios**

Not all sourcing contracts are suitable for managed services using output- and outcome-based commercial models. Such models should be employed only after careful consideration. Output- and outcome-based service delivery and commercial models are likely to work well when a majority of the following conditions are satisfied:

- The proposed work is standardized and can be offered by the service provider in a repeatable manner on a sustained basis.
- The scope of work can be decomposed into smaller units of work/consumption (e.g., tickets, applications, devices).
- The proposed work is sufficiently large to allow economies of scale.
- The buyer is willing to transfer some control to the service provider.
- The service provider will have adequate rights to proactively optimize processes, technology and people.

### The Future Sourcing Paradigm

[Figure 4]
## Aligning Managed Services with Alternate Commercial Models

<table>
<thead>
<tr>
<th>#</th>
<th>Commercial Model Type</th>
<th>Commercial Model</th>
<th>Definition</th>
<th>Best-Fit Scenarios</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Traditional Commercial Model</td>
<td>Time &amp; Materials (T&amp;M)</td>
<td>The buyer pays a fixed hourly rate for resources provided by the service provider.</td>
<td>A pure T&amp;M model is rarely used for pricing managed services contracts.</td>
</tr>
<tr>
<td>2A</td>
<td>Fixed Bid</td>
<td>The service provider charges a fixed fee for clearly defined deliverables.</td>
<td></td>
<td>Deliverables, scope and workload are well defined.</td>
</tr>
<tr>
<td>2B</td>
<td>Fixed Capacity</td>
<td>The buyer agrees to procure a fixed quantum of capacity (e.g., person-months) at a defined rate, for a fixed duration.</td>
<td></td>
<td>A varying range of services is expected (e.g., small enhancements, small projects, etc.).</td>
</tr>
<tr>
<td>3</td>
<td>Fixed Bid/ Capacity plus T&amp;M</td>
<td>The contract has a fixed component (priced using fixed bid/capacity) and a flexible component (priced using T&amp;M).</td>
<td></td>
<td>A varying range of services is expected.</td>
</tr>
<tr>
<td></td>
<td>Alternate Commercial Model</td>
<td>Application-Based</td>
<td>Applications serve as the unit of pricing. Pricing depends on application type and service class.</td>
<td>Repeatable services, linked to applications.</td>
</tr>
<tr>
<td>4</td>
<td>Transaction-/Ticket-Based</td>
<td>Pricing is based on the number of transactions or tickets executed.</td>
<td></td>
<td>Large work volume but requires low per-unit effort.</td>
</tr>
<tr>
<td>5</td>
<td>Device-Based</td>
<td>The unit of pricing is “device.” Pricing is applied per device based on device type and service class.</td>
<td></td>
<td>A robust demand management process in place.</td>
</tr>
<tr>
<td>6</td>
<td>Delivery Unit-Based</td>
<td>The unit of pricing is a function point, use case point, requirement point, test unit or widget.</td>
<td></td>
<td>Primarily used for managed production support and application maintenance contracts.</td>
</tr>
<tr>
<td>7</td>
<td>Service Catalog-Based</td>
<td>The buyer is offered a catalog of services with SLA commitments. Pricing can vary by service.</td>
<td></td>
<td>Can apply for various service lines depending on the maturity of service catalog.</td>
</tr>
<tr>
<td>8</td>
<td>Pay on Performance</td>
<td>Pricing is proportionate to the cost or revenue impact delivered by the service provider (e.g., reduction in per-policy cost, increase in subrogation claims, etc.).</td>
<td></td>
<td>Buyer is willing to give a sizeable amount of ownership to the service provider and in exchange wants to pay only for the cost or revenue impact delivered.</td>
</tr>
<tr>
<td>9</td>
<td>Gain-Share</td>
<td>A commercial arrangement in which the client and service provider share the upfront investment requirements and the risks and rewards of their relationship.</td>
<td></td>
<td>Buyer seeks a dramatic improvement in performance and wants a strategic partner to lead this effort.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Can be used for new developments (e.g., application development, package implementation), BPaaS, integrated multi-tower deals and large contracts where the service provider commits to an outcome (e.g., reduction in cost, increase in top line).</td>
</tr>
</tbody>
</table>

Figure 5
Quick Take

Using Alternate Commercial Models at a Large Insurance Company

Following a recent management shakeup, one of the largest global providers of insurance, annuities and employee benefit programs decided to adopt a radically new service procurement strategy. The company concluded, after a long history of procuring IT services through time-and-materials-based arrangements, that it would be beneficial to move to a managed services contracts in which the provider takes ownership across the “plan-build-run” continuum. It also agreed that over time, 80% of all commercial contracts would become non-headcount-based.

Business Challenge

A string of sub-optimal outsourcing deals and diminished IT budget had created severe cost pressures for the IT organization. The expectation to “do more with less” was increasing with every budget cut. Faced with uncertainty, IT management wanted a stronger handle on work procured from third-party providers. In particular, the company decided that all future outsourcing deals needed to accomplish the following:

• **Transparency:** Consumption must be transparent, which is essential for determining the total cost of ownership and accurate chargeback.

• **Flexibility:** Costs must be variable and aligned with the IT application portfolio and changing usage patterns driven by the business strategy.

• **Predictability:** The cost of introducing new services must be clearly outlined, and there must be an easy and intuitive way to ensure that future costs are at least as competitive as current ones.

Solution

To address the above needs, IT management decided to enter into managed services contracts with several leading IT providers, based on two broad commercial models:

• Application-based pricing for routine production services (incidents, service requests, problem management, remediation, etc.).

• Requirements unit-based pricing for application enhancements and new development (design, coding, testing, QA and UAT support).

Application-Based Pricing

According to this arrangement, sourced applications are treated as the unit of price, and each provider is paid based on the number of applications it supports. Applications are grouped by categories that are determined by attributes – such as application age, footprint, volume, user base, technology, etc. – as well as service classes (e.g., platinum, gold, silver). A price catalog was established, and applications belonging to the same category and service class command the same price. Both "horizontal" and “vertical” efficiency factors have been incorporated into the contract:

• Application prices decrease as more applications are added (economies of scale).

• Application prices decrease with every year of service (productivity improvement).

Application-based pricing offers advantages but also poses challenges. The main advantages noted so far are:

• The buyer can add or delete applications, and the costs associated with these actions are predictable. Further, the model makes it easier to identify low-impact/high-cost applications.

• The service provider can avoid the overhead of utilization tracking and reporting and can redirect this effort toward proactive optimization and the creation of efficiencies.

The main limitations of this model are that it requires the following to succeed:

• A large portfolio of applications.

• Accurate historical data over a significant period of time to arrive at an accurate price catalog. Lack of adequate historical data may be a show-stopper.

Requirement Unit-based Commercial Model

At the core of the requirements unit-based commercial model is a generic requirement unit that is treated as the unit of work. This can be a software sizing measure such as function point (FP), use case point (UCP), story point (for Agile) or test case point (in the case of testing). Baseline productivity is calculated for each in-scope application in terms of the number of hours of effort required per normalized requirement unit (e.g., four hours per function point). To make this calculation,
historical data is used at the outset to serve as the basis for pricing. Typically, the unit of work requirement for a period (e.g., a quarter) is estimated, and the service provider is contracted to deliver them.

This model has its advantages but also poses challenges. The main advantages include:

- It involves more accurate sizing measures than the experience-based estimation that often forms the basis of traditional commercial models.
- The buyer organization pays only for what it consumes.
- More accurate measurement of quality and productivity can be conducted during the course of the contract.

The main limitations that have emerged include:

- It requires agreement on what constitutes a unit of work, which often poses a challenge.
- There is lower predictability of cost and revenue for the service provider.
- Resource planning is relatively more difficult to handle due to fluctuations in demand.
- If the contracts are not crafted well, it may lead to a misalignment of incentives between client and service provider.

**Benefits**

This model has proved to be a “win-win” for both the buyer and its providers. The buyer now has an established method for predicting future business-as-usual costs and obtaining committed productivity and service improvements from its providers. And the providers now have a model that works on a risk pooling concept. Some applications are profitable, others are not, and well-thought-out price points ensure healthy profitability, on average. Although it’s early days yet, this shift in service procurement strategy is regarded by many as a model that could be replicated by other organizations.

**Looking Ahead**

As buyers and sellers apply lessons learned from large headcount-based sourcing deals, it is increasingly becoming apparent that managed services arrangements that use output- and outcome-based service delivery and commercial models are here to stay. The industry will be watching closely, and both buyers and providers must evaluate the risks involved and be prudent when embarking on such arrangements.

The key to successfully adopting these models is the ability to implement appropriate enabling conditions and safeguards. The collaborative capabilities and behaviors of both buyers and sellers of IT services will determine the extent of success. Establishing effective governance mechanisms and managing change in a planned manner are also critical requirements for success.
Footnotes

1 Based on a 12-week extensive internal study conducted by Cognizant, in which IT leaders across service lines and client partners of large accounts were interviewed, including application development, application maintenance, testing, infrastructure services and business process services.


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