Future of Work Enabler: Flexible Commercial Models

As companies adopt more flexible approaches to business process service delivery, they are also moving to new outcome-based payment models that support how businesses need to operate today.

This report is an installment in our multipart series that explores the shifts necessary for future-proofing your company.
Executive Summary

Most companies today have worked with service providers that deliver IT infrastructure, applications or noncore business processes. Businesses entering into their third or fourth contract renewal now wish to extract more value from these arrangements; after all, there is only so much work you can move offsite, and only so much process reengineering you can do to improve operational efficiency. Additionally, the forces of globalization, virtualization and new technologies — namely, social, mobile, analytics and cloud, or the SMAC Stack™ — are enabling businesses to do more than just incrementally improve their agility and reduce costs.

The cloud, in particular, is inspiring organizations across industries to become more innovative when it comes to purchasing and consuming business services, especially services that deliver “core” business processes, such as medical management in healthcare, clinical trial management in pharma, digital asset management in media and entertainment, and order management in manufacturing and retail. Whereas clients in the past had few options beyond acquiring and building their own assets for such processes and dedicating an internal IT group to manage these assets, the cloud now permits them to be delivered remotely, in a setup often referred to as business process as a service (BPaaS).

Rather than merely copying what the client already does, providers of BPaaS create a “gold copy” of the process, based on best practices, and continue investing in updates and upgrades that continuously drive performance improvements. In this way, BPaaS can enable organizations to run better — by significantly reducing the size of the IT function and in-house computing infrastructure — and run differently, by introducing new ways of working and innovative business capabilities.

Moreover, BPaaS shifts the hosting of applications and processes, as well as IT oversight, to the provider. The provider can scale investments and domain expertise to deliver services at lower cost, using global talent and advanced algorithms to address standard processes, adding customizations and reconfiguring the processes to address unique client requirements.
As companies look to their providers to deliver BPaaS, they are also taking a fresh look at the commercial structure of the deal itself to be a greater source of value. Traditional pricing structures that are based on full-time equivalents (FTEs) or time and materials are increasingly considered outmoded, as they tilt the balance of risk toward the buyer. Additionally, they encourage vendors to set low unit prices at the outset and then raise the price for volume increases, change requests and services beyond the original contract scope. What is more, traditional pricing is focused on the wrong place – the anticipated labor and time applied to delivering the service rather than the output, or business value, derived from the work performed.

Newer pricing models are premised on “outputs” rather than “inputs,” enabling the buyer to tie the services received to actual business goals and value accrued. They are also built on a variabilized cost structure that scales with demand, allowing the buyer to avoid surcharges for unanticipated decreases in service volume.

Adopting BPaaS and a flexible, outcomes-based approach to paying for business service delivery involves a range of considerations, such as the initial setup of the contract terms, accurate volume forecasting, supplier knowledge and the risk of moving to a new model. However, there are many benefits to adopting a flexible commercial model, as it supports how businesses need to operate today – and in the immediate future.

Flexible commercial models are one of the eight enablers companies need to consider when mapping their journey of reinvention for the new world of work, as described in our overview paper, “Making the Shift to the Next-Generation Enterprise.” In this installment, we will look at the many choices and considerations businesses must make when enabling new commercial models.

### Mapping the Enablers to the 3 R's

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Figure 1
Moving Toward a New Commercial Model

Moderate growth and relatively flat or declining performance at businesses worldwide are prompting big changes in how companies view business process service deals. In go-go times, it seems reasonable to enter into a commercial arrangement based on input, in which the contract terms revolve around a set number of FTEs or hours of service. However, when growth slows, it makes more financial sense to tie contracts to output, such as the cost per claim in insurance, cost per trade in financial services or customer onboarding time in media and entertainment. With more flexible, output-based commercial models, there is a link between the business volume flowing through the system and the costs incurred. The transaction levels themselves drive how much the business pays for the given service, shifting the cost risk onto the provider.

Flexible commercial models are also attractive to the growing number of businesses that want to reduce capital expenditures and transition to more flexible Op-Ex budgets. Additionally, as the services marketplace has matured over the years, providers have gained rich stores of domain experience, knowledge and intellectual property, based on their client work. Businesses increasingly expect their providers to act as value-added assets that can “sell” their expertise back to them on a per-transaction basis. Companies that take advantage of these capabilities can then reinvest the savings into core processes that either differentiate or reinforce their competitive advantage.

The attractiveness of output-based commercial models varies, depending on the type of service being consumed. For instance, software as a service (SaaS) deals often use input-based models, as they commonly involve project-based work and have a lower cost commitment. IT infrastructure and BPaaS work, on the other hand, involve fluctuating volumes based on business need and performance, and so are geared toward output-based models.

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BPaaS and output-based pricing models are also attractive for companies that wish to implement social media and analytics capabilities for the first time. Without legacy investments to defend, it is easier to justify a new approach to obtaining these capabilities, and they are also easier to consume as a service than other business functions, such as ERP.

The Reality of Flexible Commercial Models

A good example of using output-based pricing in a BPaaS setup is our work with a global pharmaceuticals client, in which we manage the entire clinical data management function on a per-transaction basis. In the past, we used a fixed team and a preset amount of resources, no matter the work volume requirement. Now, the client pays only for resources used, on a per-trial basis. In doing so, the pharma has effectively passed the risk and responsibility of optimizing operations to us and incurs costs only as its own business volume fluctuates. This arrangement has become particularly important as the life sciences industry struggles to develop new blockbuster drugs.
Another example is the work we do with a large insurance provider. We purchased the client’s technology and real estate assets and hired a team of its employees to process a significant portion of its business and then sell it back as a service, on a per-transaction basis. This provided the client with a lower total cost of ownership, transferred employment risk to its partner and secured stronger career prospects for employees. The client also realized a financial return on its historic investment in assets, while creating a mechanism to ensure strong ongoing investment to develop these assets and create a world-class infrastructure.

Challenges and Considerations

Moving from a traditional service provider setup to BPaaS and output-based pricing involves many changes, challenges and considerations, namely the following:

- **Understanding who controls what**: In a traditional service provider scenario, it is critical to build a strong client-provider relationship, as well as a solid contract, particularly as the buyer gives up control in exchange for committed benefits. But this is even more the case with BPaaS and output-based pricing models. The client needs to be confident that the vendor will continue to invest in and develop the platform to stay at the forefront of the market. Otherwise, the buyer risks ending up with an outdated platform, making it difficult to bring work back in-house.

- **Redefining relationships**: Moving to an output-based pricing model changes the relationship between provider and client, and it takes time for each to rediscover and acclimate to their new roles. Collaboration becomes more essential than ever, not only for business effectiveness but also for business agility and regulatory compliance. For instance, the more feedback buyers provide on outcome performance, the better able providers will be to fine-tune their processes and infrastructure.

- **Increased pricing certainty**: Clients are able to more clearly identify total cost of ownership, as they are effectively buying a whole solution.

- **A shift in responsibility to the supplier for raising productivity and reducing the total cost of service delivery**: Suppliers accept responsibility for providing the whole solution and for committing to price reductions across the service they provide, including people, process and technology.

- **A focus on outcomes, increasing service quality and supplier responsiveness**: Contractually, the focus on process outputs or business outcomes draws the commercial interests of customer and supplier closer together.

- **Better linking of business needs with contract terms**: By focusing on outcomes, the contract closely mirrors the needs of the business. For example, if business volumes drop, total transaction charges will similarly decline.

- **Improved risk management**: Clients are no longer exposed to project implementation risks or the need to invest in upgrades or new technologies.

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**Quick Take**

**Flexing Business Process Work**

Adopting a flexible, outcomes-based approach to paying for IT and business service delivery can deliver a wide range of benefits, including:

- Increased pricing certainty: Clients are able to more clearly identify total cost of ownership, as they are effectively buying a whole solution.

- A shift in responsibility to the supplier for raising productivity and reducing the total cost of service delivery: Suppliers accept responsibility for providing the whole solution and for committing to price reductions across the service they provide, including people, process and technology.

- A focus on outcomes, increasing service quality and supplier responsiveness: Contractually, the focus on process outputs or business outcomes draws the commercial interests of customer and supplier closer together.

- Better linking of business needs with contract terms: By focusing on outcomes, the contract closely mirrors the needs of the business. For example, if business volumes drop, total transaction charges will similarly decline.

- Improved risk management: Clients are no longer exposed to project implementation risks or the need to invest in upgrades or new technologies.
• **Adopting new roles across the organization:** Different commercial terms require new forms of governance, better accountability and the need for different communication streams within the organization, as well. In particular, the IT, procurement, finance and program management functions need to develop new capabilities, without undermining the economics of moving to an output-based BPaaS model. For instance, CIOs need to be able to engage in a fluid discussion with the CFO and COO about how these new approaches impact cash flow and financial reporting models.

• **Moving from “inputs” to “outputs”:** Defining transactions or units of work requires a high degree of collaboration, both inside the organization and with the provider. Outputs need to be rigorously specified and defined, with no room for ambiguity. This entails retaining traditional service level agreements (SLA) to define responsiveness and time limits, while paying more attention to creating operational level agreements (OLA) that measure value in a new way. An example is a pharmaceuticals company whose goal is to get safer drugs to market faster; it would need to define specific outputs that pertain to speed of drug development and safety of the drug.

   Even organizations with a long history of working with service providers will not have experience in specifying outputs to this level of detail. Businesses need to establish a governance team that assumes responsibility for administering these metrics, tracking them, instituting a reward/penalty structure and periodically reviewing and aligning these new measures.

• **Accurately forecasting volumes:** Companies also need to institute a way to accurately predict transaction volumes, both to stay within the parameters of the commercial model and to give suppliers sufficient lead time to absorb volume variations. It’s all well and good to variabilize costs, but it does require predicting volumes to a reasonable level of accuracy. If the target is 100 transactions, the vendor will normally allow a latitude of between 90 and 110 and price between 80 and 120. They will still do the work, but it will be more expensive on a per-unit basis. Making these predictions requires sufficient visibility into the processes, as they need to be made not weeks but months in advance.

• **Balancing standardization and customization:** Moving to a platform owned and developed by a third party will necessarily drive standardization, which is usually desirable but can also be painful to achieve. Businesses need to be fully confident that the service provider will make continuous investments in the platform and can manage a multi-tenanted platform. There is a risk – especially for smaller companies – that one or two dominant companies will influence the way in which the platform develops and where investments are targeted. Not only does the service provider need to ensure that it is invested in each client’s business model, but it also needs to develop the platform in line with emerging and evolving trends and technologies.

CIOs need to be able to engage in a fluid discussion with the CFO and COO about how these new approaches impact cash flow and financial reporting models.
Words to the Wise

Output-based pricing models are an emerging approach, with few precedents or industry benchmarks to follow. Compared with input-type data – the hourly salary of a claims administrator or Java programmer, for instance – it is much more difficult to obtain output-based data, such as the cost to process a complex claim.

But their relative immaturity is not a good reason for waiting too long to take advantage of BPaaS and output-based pricing models. Early movers can wield more influence over the provider’s platform and dictate how processes can be optimized to their needs, simply by virtue of being the first customers. Once more companies move to the platform, there will be far less opportunity for differentiation. A conservative approach would be to run a flexible commercial model in parallel with a traditional input-based approach for a year or so and track the progress between the two. This would reveal the benefits and risks of the output-based approach.

Short-term thinking may seem to be the best way forward in today’s uncertain economic climate, but organizations shouldn’t be so easily swayed. While it’s tempting to fall back on familiar patterns of procurement and managing vital business processes, doing so is a recipe for stagnation. It is only by embracing more flexible commercial models that organizations will be equipped to contend with today’s business challenges, while gathering the wherewithal to contend with tomorrow’s operational requirements.

About the Author

Martin Kochman is Cognizant’s Vice President of Business Process Services. He has held multiple senior consulting and executive management roles and has extensive experience in customer relationship management, shared services operations and global transformational sourcing programs. Martin has designed, built and managed centers in the UK, India and Eastern Europe, and has operated multiclient, multivendor, multilingual contact center operations. He also has negotiated and implemented many innovative outcome-based commercial contracts, including asset monetization and sale and lease-back arrangements. He can be reached at Martin.Kochman@cognizant.com.
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