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DYNAMICS OF EMERGING PRICING MODELS IN BUSINESS PROCESS MANAGEMENT

A Perspective on Current Prevalence and Future Adoption

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After two decades of outsourcing and offshoring, the benefits from traditional sourcing models are plateauing in terms of cost savings and talent access. The focus is gravitating toward under-exploited benefits of process reengineering/standardization, impact on business metrics such as incremental revenue growth and reduction of working capital.

Enterprises need new sources of value beyond cost savings, and service providers need new sources of competitive differentiation and margin levers. Emerging pricing models — transaction and outcome-based pricing — provide an opportunity for both parties to shift the sourcing conversation to value-based models.

Pricing models in Business Process Management (BPM) have been evolving with time, adapting to client needs. While Finance and Accounting Outsourcing (FAO) mostly has seen pricing based on full-time equivalencies (FTEs), its future will likely experience a higher prevalence of transaction-based pricing. The major groups of procurement processes, source-to-procure and procure-to-pay appear amenable to outcome-based pricing and transaction-based pricing, respectively. Transaction-based pricing is the norm in contact center outsourcing. Further, numerous niches within industry vertical BPM are suitable for outcome-based pricing.

Of course, the right pricing model can be specific to the engagement, and several cases of alternative pricing models can be found in the horizontal BPM service lines mentioned previously.

More important than prevalence statistics is the fact that alternate constructs have been a common discussion point in sourcing transactions of late. Transaction-based pricing and business outcome-based pricing afford benefits that are not possible with FTE-based models. Utility-based pricing helps enterprises better manage peaks and troughs in demand and transfers some of the risks to the service provider. Such pricing offers deeper and more valuable insights into demand and consumption patterns, details that are typically opaque in the FTE-based world. By decoupling revenues from the FTE count, alternative pricing incents the service provider to exploit the latent productivity potential with the use of tools and best practices while still meeting the required performance levels.

KEY QUESTIONS ANSWERED

- **What is the prevalence of the new models and the likely long-term trajectory?** Outside of human resources outsourcing (HRO) and contact center outsourcing, transaction-based pricing is not seen often enough. Outcome-based pricing, however, is already a feature in every service line, albeit in a limited way. Several niches in the broad spectrum of vertical BPM should see a rise in outcome-based pricing. As proximity to revenue generation increases for the service provider, so does the likelihood of outcome-based pricing.
- **How would an enterprise evaluate the new pricing models for a specific engagement?** The decision depends on availability of data, readiness for the light-touch managed services model of sourcing delivery management, the degree of trust and depth of relationship with the service provider, and — crucially — the maturity of the service provider. Only a mature service provider that is confident in its ability to realize the latent benefits for both the buyer and provider of services can embrace new pricing models.
- **What can an enterprise do to ensure realization of the anticipated benefits of the new pricing models?** Clearly define the output and/or the outcome, devolve the required process control of responsibilities to the service provider, and adapt service governance to a mature managed services paradigm.

THE NEWER PRICING MODELS: TRANSACTION-BASED AND OUTCOME-BASED

For the sake of clarity, it is useful to define key terms at the outset.

Transaction-based pricing (or utility/output pricing):

Transaction-based models involve pricing by unit of output, such as invoices processed, customer accounts reconciled, insurance claims processed and checks disbursed. The defining attribute of transaction-based pricing is that output — not input or effort — becomes the billing resource unit. Implicitly, the service fee is decoupled from FTE counts. It is worth pointing out the subtle contextual difference between transaction- and utility-based pricing, given that the latter is used frequently in the context of a full stack bureau service or business process as a service (BPaaS).

Outcome-based pricing: Outcome-based pricing ties service provider fees to a metric directly relevant to the business and represents an outcome that is far from certain. Examples of outcome-based pricing would be linking fees to customer churn rate reduction, customer satisfaction, incremental revenues earned and cost savings. Typically, the outcome-based “at-risk” component of the pricing represents no more than 10 to 20 percent of the total fees.

The defining feature of the aforementioned models is that they are decoupled from a fixed capacity of FTEs; also, the governance involves managing results and milestones, not service provider resources. These models hold promise for both enterprises and service providers. After decades of outsourcing, enterprises need new efficiency levers. Third- and fourth-generation outsourcing is not driven by cost savings alone. A third- or fourth-generation outsourcer is already managing per-FTE costs effectively through offshoring. The objective, then, is to focus on building variable capacity and leveraging capabilities of the service provider for higher business impact.

From the service provider perspective, FTE-based pricing precludes the possibility of earning margins significantly above industry averages. On the contrary, in an industry that is witnessing increased competition, FTE-based pricing can result in the race to the bottom. Non-linear pricing* incents the service provider to apply its best practices and tools to both achieve high margins and expand the benefits “pie” for both parties.

Also, in a mature and competitive market, service providers require new levers for growth and new sources of differentiation. **The ability to assume additional risk — the vehicle for which is often the pricing model — is one of the key ways to differentiate in a crowded market.**

*Non-linear pricing: Headcount decoupled from growth in business / outcomes

THE CURRENT STATE OF PRICING

Our analysis and research informs the following as the current state and outlook for the major services segments:

FAO: The dominant pricing model in Finance and Accounting Outsourcing (FAO) continues to be FTE-based. The prevalence of transaction-based and outcome-based pricing is about 10-15 percent and 5 percent, respectively. Going forward, we expect growth in the adoption of transaction-based pricing. Change is likely to be gradual, though, countering inherent challenges such as processes in FAO that are dissimilar across enterprises or supporting technologies that are highly specific to the enterprise. A few processes in FAO are high in volume and rule-based (e.g., account payable invoice processing, cash application in account receivable), which lend themselves well to transaction-based pricing.

Procurement: The dominant model is FTE-based. Source-to-procure is slightly different and has higher adoption of outcome-based or gain-share arrangements. The focus for both parties is to reduce the spend by improvising procurement practices, such as consolidation of providers and undertaking specific actions based on performance/volume insights using data analytics.

HRO: Pricing constructs for Human Resources Outsourcing (HRO) processes are fairly standardized, using pricing per employee for the scope of services outsourced. HRO is a mature segment of BPM services and is more often than not offered by service providers as a platform-based service.

In talent management, payroll and benefits administration, the most common pricing unit is the participating employee. In recruitment process outsourcing, it is the “hire.” In effect, “per participating employee” is pricing by a standard bundle of transactions. The construct might be different in specific HRO functions, such as learning management, where pricing is by course delivered. Gainsharing happens in the context of self-service: cost savings from self-service are shared between the client and the service provider, with such an arrangement currently seen in about 25-35 percent of HRO engagements.

Contact center services: Contact center pricing is rarely FTE-based. Transaction-based pricing (such as per call, per email) and time unit-based pricing (minutes on the phone) are typical. ISG has observed few instances of gainsharing.

The choice between time unit-based pricing and transaction-based pricing depends on what the client wants to manage and what behavior the client desires from the service provider. With transaction-based pricing, service providers have a tendency to reduce the call duration, which can be detrimental to customer satisfaction. Transaction-based pricing is not advised without at least 12 months of historical data.

Contact center outsourcing is another mature segment, with many enterprises in the third and fourth generation of outsourcing. Pricing constructs here have not really changed, and change is unlikely in the near term. However, niches within contact center outsourcing are amenable to outcome-based pricing. When the contact center doubles as a sales or overdue invoice recovery channel, for example, the pricing framework tends to be outcome-based. In such cases, it is common to base a percentage of fees on revenues earned or amount of overdue invoices collected through the contact center channel.

Vertical BPM: This is a very diverse segment, with industry-specific processes spanning banking, insurance, financial services, logistics, travel and transportation and others. There are numerous niches within vertical BPM in which outcome-based and utility-based pricing are common. Any process related to revenue collection and recovery is likely to feature outcome-based pricing. *(Please refer to the case study on the airline industry on page five.)*

LONGEVITY OF THE FTE-BASED MODEL

For all its limitations, the FTE-based model has the virtue of simplicity and is an easy model for assessing the benefits of a new sourcing arrangement. Further, it is easier to benchmark the cost in such a model because there is enough data available for a range of skillsets and experience levels across regions.

Regulations and other security norms can sometimes result in the client tightly controlling the environment, including PC configuration, security and access to service provider resources. The engagement then becomes primarily about labor arbitrage and access to talent for process transformation and standardization.

Finally, what often goes in favor of the FTE model is the fear that the service provider will make disproportionate margins on the account. Ironically, the shift to value-based thinking is not common among sophisticated outsourcing organizations.

WHEN IS OUTCOME-BASED PRICING VIABLE?

For outcome-based pricing to be viable, service providers need greater end-to-end control of the process, right through to the outcome. Such pricing also requires the service provider to have mature operations. A service provider that is willing to stake a significant percentage of fees on a business outcome needs to have a track record of delivering the required results. This is typically underpinned by sophisticated tools for risk assessment and effort estimation, as well as domain expertise. The service provider also needs to be at a stage of evolution where new margin and growth levers are necessary.

An extreme in the rarefied world of outcome-based pricing is pricing tied to a financial metric, such as incremental revenues. Percentage of revenue-based pricing is rarely seen in the horizontal BPM service lines – FAO, HRO, contact center and procurement. Direct linkage with revenues is hard to come by. Outcome-based pricing, particularly incremental revenue-based pricing, is more common in vertical BPM. *(Please refer to the case study on revenue recovery for airline industry on page five.)*

WHEN IS TRANSACTION-BASED PRICING VIABLE?

In ISG's experience, the following factors indicate high applicability of the transaction-based model of pricing in BPM services.

When the service is amenable to disaggregation into a finite set of standard transactions: As would be obvious, a necessary requirement for transaction-based pricing is that the service must comprise a manageable set of well-understood and clearly defined transactions. For example, it is much easier to define units of work in accounts payable and customer service than in financial planning and analysis, record to report or investment research or analytics.

When the enterprise needs to scale rapidly: Sometimes a rapidly growing enterprise lacks the resources to scale rapidly, so the service provider takes on a high measure of risk and upfront investment. Transactions of this nature often involve the entire technology stack, including applications and infrastructure. Typically, the enterprise is focused significantly more on value than on minimizing service costs. In such cases, transaction-based pricing has more in common with outcome-based pricing because a successful transaction represents a complex orchestration of hardware, software and service.

When FTEs are a relatively small proportion of total

costs: Transaction-based pricing tends to be the dominant construct when FTE costs are a relatively small fraction of total costs. A few common examples from banking are ATM maintenance, mail and scanning (per item), outbound email, and cash-in-transit deliveries. Each business process listed above involves a fixed cost per unit with a unit rate for variability. Of course, low FTE costs often indicate a high level of automation.

A distinction needs to be made between pricing per transaction that doesn't change the underlying operating model and pricing based on the utility model. An essential precondition for the utility model is standardization of services across multiple clients. Typically, such transactions are bundled with the underlying information technology system as well. Such a framework offers true variability in capacity to each client and is based on a shared resources model (with the required data security, etc., as necessary). As would be expected, utility pricing affords a better per-transaction price point.

It is useful to remember that, notwithstanding the nature of the model (whether mainstream or alternative), price is a function of cost, volume and risks. If the delivery model is dedicated to a single client, the cost and the risk of volume fluctuations would be built into the price. It is therefore imperative to look for a shared service delivery model and a shared delivery platform for true variable capacity, assuming the inherent real and perceived data risks are acceptable.

THE PATH TO NONCONVENTIONAL PRICING CONSTRUCTS

It is indisputably clear from ISG research on nontraditional models that such constructs take time and do not typically begin when the contract is signed. Engagements typically begin with the conventional FTE-based models and can shift to transaction-based pricing when the relationship evolves to a trusted partnership and adequate data has been obtained on cost and volumetrics. Cost, baseline and target values of cost and performance metrics need to be measured before outcome-based pricing constructs can be agreed upon. Finally, the alternative pricing model experiment is best started small, with process areas most amenable to such pricing, and then gradually expanded in scope.

ALTERNATIVE PRICING MODELS: CASE STUDIES

This section presents three WNS cases of alternative pricing models, each covering the business need for a non-FTE model, the transition and benefits accrued. WNS, a leading BPM service provider, has been at the forefront of developing new pricing models with its clients and considers those models to be an important element of its future way of doing business.

WNS's experience with outcome-based pricing in the airline industry

Airline ticket pricing is more often than not prone to errors, both by agents and the airlines' internal ticketing offices. Ticket pricing needs to conform to a plethora of rules, every one of which is prone to its own set of errors. The agent could fail to charge the right amount of tax and fuel surcharge or sell the ticket at a discounted price despite the fact that the rules defining the discount are broken. For example, tickets are issued at a discounted price even when they fail to conform to the allotted time between reservation and booking; a business class seat is allocated at an economy class price; a discount could be valid only for a window of time, but the ticket is still issued outside the time window for the discounted price; or an agent charges more commission than is due.

A reconciliation process is necessary to ensure that the right fare has been charged. Tickets need to be audited to detect the difference between the right ticket price and the price charged by the agent who violated one or more of the pricing rules.

WNS runs auditing operations for several airlines around the world and processes more than 100 million transactions a year. The reconciliation process typically begins with WNS's proprietary VERIFARE® solution, which takes ticket price data in a standard format and decides whether the ticket warrants manual auditing. When a discrepancy is discovered, agents are charged the difference, and are sent a "debit memo." The agents have an industry-specific, market-driven timeframe to honor the debit memo or dispute the charge. WNS manages the entire process end-to-end, including dispute resolution and collection.

The engagement initially started as an FTE-based model and was later transitioned to an outcome-based pricing framework. WNS's revenue is accrued based on the Identified Recovered Amount through the fare audit process and received as a percentage of the amount recovered. The entire amount is at risk. There are no

fixed fees or any other non-outcome-based pricing metrics.

In addition to auditing services, the team leverages its privileged position as a custodian of transactional data to provide analytics.

WNS's experience with outcome-based pricing at large U.S.-based travel company

This case study is about transformation of an online travel company's offline channel from customer service management to sales -- a cost center to a profit center. The company's challenge was managing its sales operations more efficiently in a growth environment to increase revenues.

As a long-time BPM partner, WNS evaluated its client's existing model and observed that the online channel was the primary source of customer acquisition and revenue generation. Since most of the client revenue came from the online channel, the organization needed to leverage its shared services to explore revenue-generating possibilities by linking with the online channel.

To counter this dependence, WNS proposed an offline channel through its proprietary Sales Center of Excellence (CoE) model. In collaboration with its client, WNS decided to transform the customer acquisition process by integrating best practices from online and offline sales channels while applying customer intelligence derived from data on buying behavior. A "cross-sell opportunities" model was created by analyzing customer service records to ensure the company was making the right offer to the right customer at the right time and at the right price.

Initially, the model worked on FTE-based pricing. After two years, it gradually evolved to a transaction-based model (price per interaction, i.e. per call, chat, and email). Now a portion of the fee is based on outcome. In some of the client's business units, pricing is entirely governed on an outcome basis.

As the shared services function was reformed into a revenue channel, the cross sales ratio grew from 3 percent to 8 percent, offline sales went up by 50 percent, sales conversation went up by a factor of 1.5, and revenue per call went up by 20 percent. Customer satisfaction improved by almost 50 percent. WNS's transformational initiatives spanning technology, web analytics and operational improvements played a significant role in its client's overall business performance.

WNS's experience with transaction-based pricing at a utilities major

WNS is engaged with a major European utilities company for managing its back-office processes, including exceptions related to billing, payment, and relocation processes (gas and electricity services). The engagement began with an FTE-based pricing model. The client was experiencing a significant surge in volume of exceptions, resulting in a five-fold rise in the numbers of FTEs servicing the client. The priority at the beginning of the engagement was to stabilize the inflow of exceptions and reengineer processes.

Gradually, the productivity benefits from process transformation began to plateau. The client wanted to explore new sources of efficiency and offload some of the risks to the service provider. WNS proposed a transition in the engagement approach to bring about better synergies. This led to an adoption of a transaction-based model. Under the transaction-based framework, every exception type was assigned a price, a baseline volume and a deadband. The new pricing model yielded a number of benefits, including a 15 percent reduction in cost, resulting from reduced idle time, resource pooling, and cross-skilling. Client satisfaction levels improved significantly as well.

Over the next three years, the engagement prospered under the transaction-based model at the same time the scope of the engagement at a relationship level doubled. However, in the context of exception management processes, the transaction-based model has an inherent challenge – the service provider does not have an incentive to reduce exceptions. Hence, in collaboration with the client, WNS began the process of migrating to a customer account-based model. With the new pricing framework, the service provider has taken on additional risk and is invested in the client's business more than ever. In summary, the engagement has evolved towards greater service provider alignment with business value, and the pricing model has been a key vehicle of such an alignment.

IN CONCLUSION

The confluence of several key trends bodes well for the future adoption of newer pricing models. The first is the service provider's quest for sources of nonlinear revenues. The second is the rise of enabling technologies. The need for nonlinear revenues provides the objective, and technology provides the means. Finally, the maturity of the customer makes the outcome real.

Several contemporary technologies serve the cause of alternative pricing models. At the time of planning, process modeling and analysis techniques enable the service provider to promise outcomes with a reasonable level of risk. Additionally, enabling technologies for automation are numerous and growing rapidly.

The future belongs to BPM service providers who can combine vertical knowledge, technological sophistication (including analytics and automation capabilities) and an appetite for risk. These characteristics are paving the way for alternative pricing models.



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