EQUATERRA

The Outsourcing and Insourcing Advisory Firm

Pricing Alternatives & Methodologies | 2005

IAOP Chapter Meeting – October 28, 2005

EquaTerra Services Overview

Supporting the SG&A process-improvement lifecycle...

Knowledge and Education → **Strategy and Assessment** → **Insource/ Outsource Advisory** → **Governance**

SG&A processes - Human Resources, Finance & Accounting, Information Technology, Procurement and CRM

Industries - Manufacturing, Consumer Products, Utilities, Energy, Financial Services, Healthcare, Public Sector and Others

...enabling service-delivery excellence through outsourcing and insourcing.

Our Clients

EquaTerra

- Exelon
- Capital One — what's in your wallet?
- Xcel Energy
- NiSource
- Unilever
- Delta — delta.com
- AT&T
- Bristol-Myers Squibb Company
- Blue Cross Blue Shield of Rhode Island
- GM
- Goodyear
- Baker Hughes
- California Courts — The Judicial Branch of California
- Cooper
- ChevronTexaco
- Deutsche Bank — Leistung aus Leidenschaft.
- The Gillette Company
- John Hancock
- Lockheed Martin — We never forget who we're working for™
- Nestlé — Good Food, Good Life
- SAP
- TXU Energy
- The Pepsi Bottling Group
- Rockwell Collins
- Prudential Financial — Growing and Protecting Your Wealth®
- Weyerhaeuser
- United Technologies
- Williams
- Southern California Edison — An Edison International® Company
- Rohm and Haas
- Charles Schwab
- Burlington Northern Santa Fe Railway
- Sempra Energy
- ONEOK
- Whirlpool
- Honeywell
- Borland
- Bank of America — Higher Standards
- Alvarez & Marsal

Value and Measurable Results

EquaTerra

Our approach delivers:

Reduced Risk

Greater than 80% improved relationship success rate when advisors are used in Outsourcing selection

You will be ready to govern

Reduced Cost

Outsourcing will reduce overall cost structure (20-50% less)

Utilizing EquaTerra can increase savings

(6-10% additional savings)

Reduced Time to Implement

Increased transaction speed (50-70% faster)

Improved Knowledge

Industry-leading Advisors

100% knowledge transfer

Return on Investment

Payback is usually between 3 and 6 months

Total payback typically exceeds 20 times investment

"EquaTerra introduced the concept of relationship management as a way to mitigate risk AND preserve value".

Williams Companies

The Pricing Continuum

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Evaluation Criteria

- Budget Constraints
- Price/Quality Judgments
- Benchmark Information
- Market Evaluation
- Purchase Situation Factors (Time Pressure)
- Usage Situation Factors
- Expected Price Range of Substitutes
- Cost of Search

Constraints

- Data Quality - Volumetric
- Data Quality - Financial
- Scope Definition
- Scope Change over Time
- Customer Desired Control
- Customer Desired Risk
- Cost / Price Transparency
- Cost Elasticity
- Complexity to Manage
- The Customer

Methods

- Fully Fixed
- Fixed by Scope Element
- Fixed / Variable (ARCs & RRCs)
- Variable - Cost Plus
- Variable w/target price - open book
- Fully Variable - Activity Based

Goals

- Value Realization
- Drive Behaviors & Accountability
- Improve Risk Profile
- Operationally Executable

Goals of Pricing

Value Realization

- Reduce Costs
  - maximize long-run profit?
  - maximize short-run profit?
- Obtain a target rate of return on investment (ROI)
- Increase Cash Flow
- Variablization of Fixed Cost Structure

Drive Behaviors (Accountability)

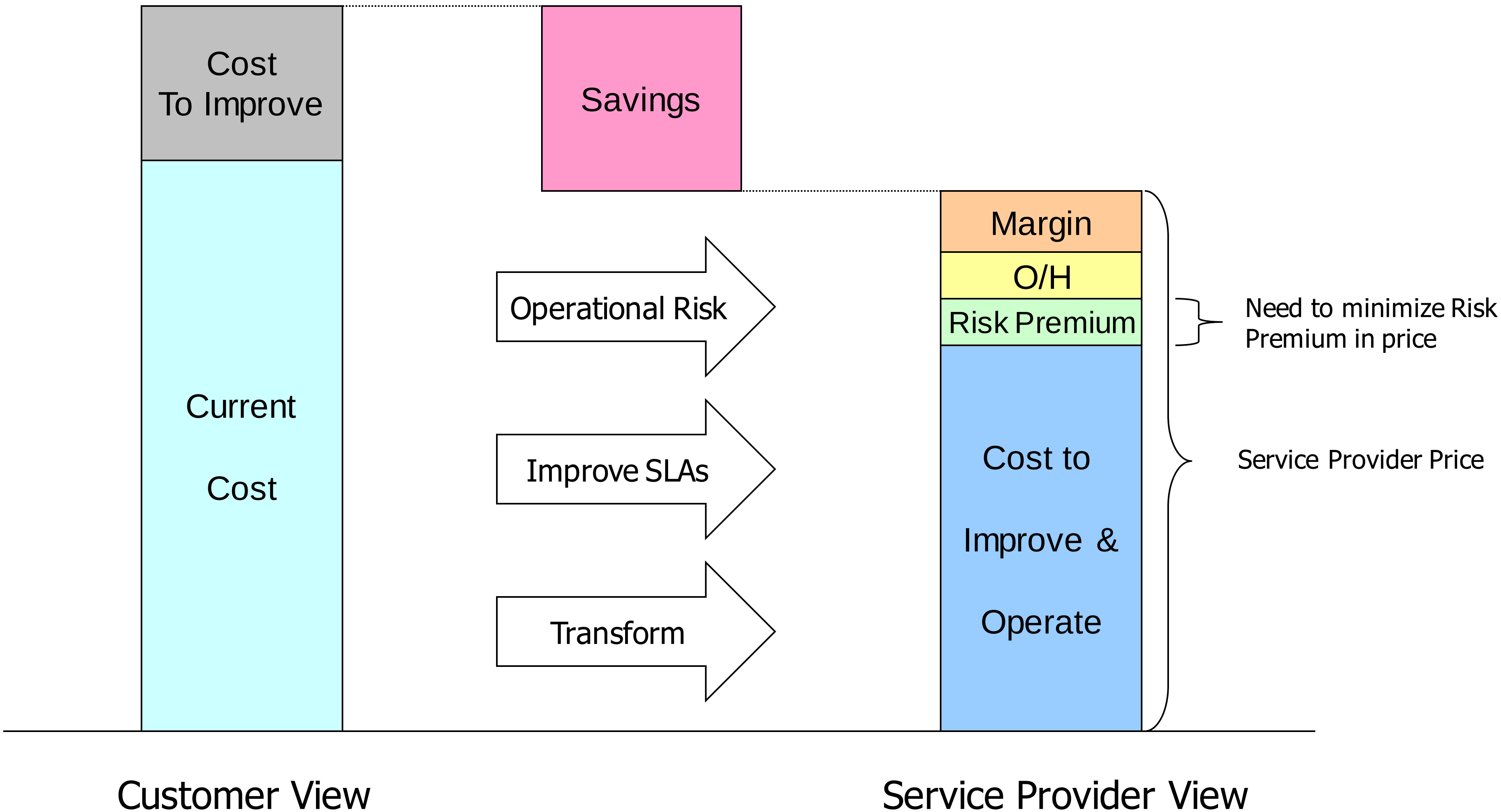
- Internally (i.e. consumption management)
- With the Service Provider
- With 3rd Parties

Improvement of Risk Profile

- Shift risk to Service Provider (Operational, Financial, Etc.)

A Pricing Structure that is Operationally Executable

The Bridge – Customer view vs. Service Provider view



The Pricing Spectrum – Which Methodology to Use?

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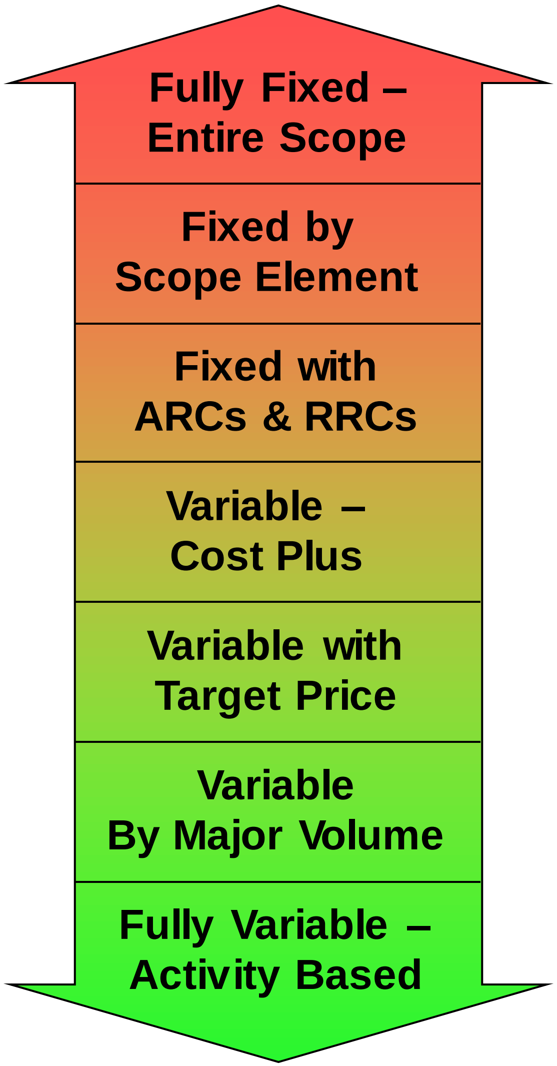

- There are times and places for fixed pricing
- Previous customer experience is important
- Fixed Price does not equal minimal customer involvement

- ARCs & RRCs is a common approach
- Closely approximates SPs Cost Structure
- Good initial starting point for price structure

- Depending on the speed to deal and quality of customer information, this may be the option
- This should not be where you start your pricing journey, but it may be where you end up.
- Post deal management overhead could be an issue here

- Customer's love it (if they have the data), SPs hate it
- Closely approximates the customer's cost structure
- Good Volumetric information is critical here

Fixed Price Methodology

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- **Definition - A fixed dollar amount to be paid for a defined scope and level of services within a defined timeframe**

- **Customer's Perspective - Fixed Price is low risk assuming no significant volume fluctuations**

- **Service Provider's Perspective - Service Provider takes on the risk and charges a price premium to do so**
  - Service Provider absorbs over-runs if not managed
  - But offers greatest opportunity for profit potential

Fixed Price Methodology

- **With a Fixed Price, both Service Provider and Customer have a risk relating to volume fluctuations**
  - If volume increases and no change in fees, Service Provider's margin falls or may be eliminated
  - If volume decreases, Service Provider's margin increases and Customer's potential savings are lost to Service Provider
- **Potential Fixed Price Usage includes well defined short term projects and ADM services, more so in Application Maintenance than Application Development because of scope definition issues with Development**
- **Additional areas where fixed pricing can work are transition and transformation deal components where significant definition has been completed by both parties prior to contract signing**
- **Typically not suitable for Volumetric driven ITO, FAO, or HRO type deals**
  - Greatest potential for significant volume fluctuations
  - Customer's price performance may be lost
  - No Service Provider incentive to improve efficiency

Combination Fixed / Variable (ARCs / RRCs) Methodology

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- **Definition - Baseline price to be paid (Fixed Component) for Baseline Resource usage with Additional Resource Charges and Reduced Resource Credits applicable to volume fluctuations (Variable Component)**

- **Customer's Perspective - Allows for flexibility and unit price certainty with volume fluctuations**
  - Provides financial transparency and the flexibility to control expenditures in a changing environment
  - Transfers risk of achieving projected cost savings at the unit cost level to Service Provider
  - Technology price performance built into pricing structure
  - Benchmark provisions allow for competitive adjustment

Combination Fixed / Variable (ARCs / RRCs) Methodology

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- **Service Provider's Perspective - It fairly accommodates volume fluctuations which are largely beyond Service Provider's control**
  - Service Providers can recover their cost in the event Customer's circumstances change
- **Potential uses includes Mainframe, Servers, Desktop, Help Desk, Business Process and AD/M**
  - Greatest potential for significant volume fluctuations
  - Customer's price performance built into Baseline
  - Service Provider incentive to improve efficiency
  - More components for the Customer to manage
- **This method is more aligned with the Service Provider's cost structure**
- **Because there is a significant fixed component, this method is less sensitive to change.**

Cost Plus Methodology

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- **Definition for Cost Plus – Service Provider's cost + a margin amount**

- **Customer's Perspective – In a true cost plus model, execution risk is firmly with the customer**
  - **Customer absorbs over-runs if not managed**
  - **Offers a significant opportunity for cost reduction for the customer if the Service Provider delivers**

- **Service Provider's Perspective – Mitigates risk and guarantees a profit margin on top of the cost base**
  - **Service Provider must agree to share internal cost structure with customer, which can be problematic for some SPs**

Cost Plus Methodology

- If the ARC / RRC Methodology is the opening position for pricing, Cost Plus is probably the last option.
- Used when the customer does not have the underlying data or the time to collect it
- Used in deals with aggressive timelines and where any type of data collection is not an option
- Also used when the scope can not be firmly articulated
- Thought should be given to having the ability for the customer to be able to pivot to either an ARC / RRC method or Activity based method at some point in time.
- Based on the bullets above, this is clearly an exception process
- Target Cost Method to be discussed next should be ahead of this option

Fully Variable (Activity Based) Methodology

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- **Definition – A fully variable price where both fixed and variable cost elements are included in the unit price (i.e. telephone & electric bills)**
- **Customer's Perspective – This mirrors the way we do business. If we consume more units we pay more and if we consume less, we pay less which drives the right behaviors**
- **Service Provider's Perspective – Service Providers don't like this as this creates a number of problems for them from a deal minimums perspective and being able to recoup their fixed costs that have been spread over the life of the deal.**

Fully Variable (Activity Based) Methodology

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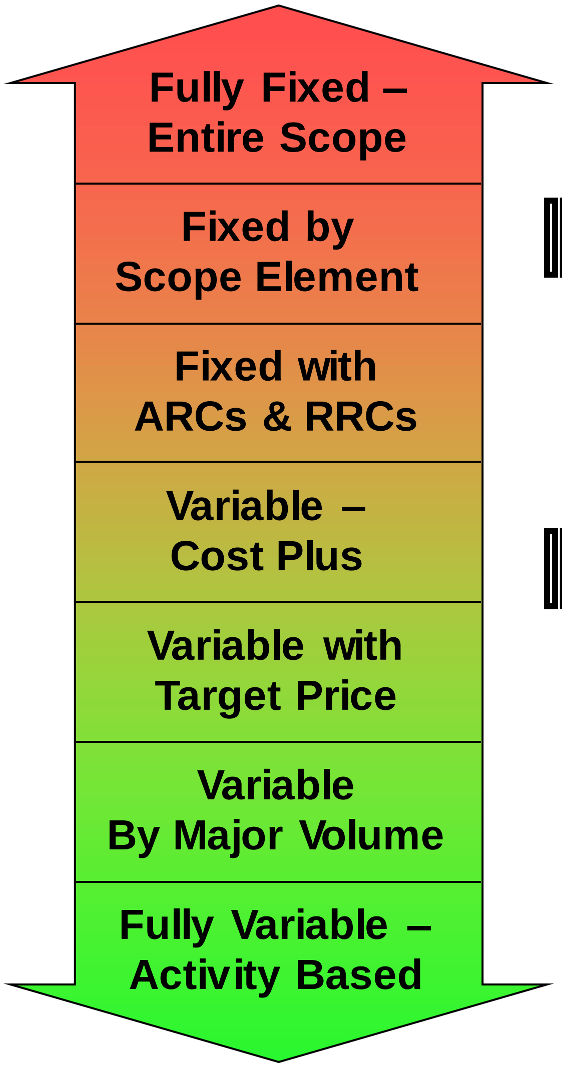
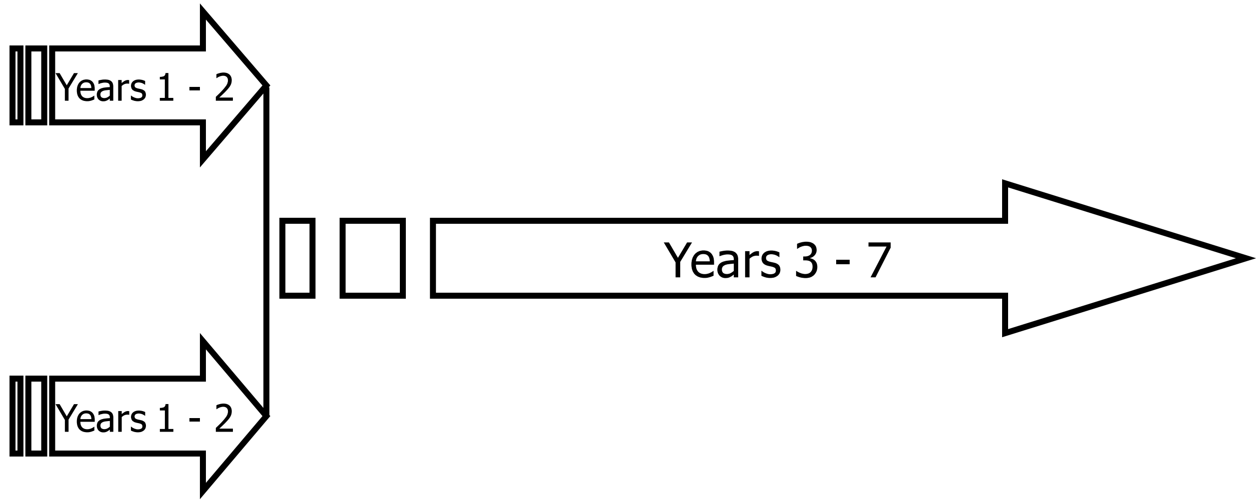
- Like this model in general, but concerns around creation of arbitrage situations between the Service Provider and the Customer
- What do you include in the fully variable price?
  - Service Fees?
  - Transition Costs?
  - Transformation Costs?
- As previously stated, having good underlying data is essential with this method
- The Service Providers are resistant to this on a couple of different levels
  - Recovery of Fixed / Sunk Costs
  - Minimums
  - Discomfort to align with customer's cost drivers
- When going down this path, we need to listen a little closer to the SPs in our creation as some of their insights may prove helpful

The Pricing Spectrum – Closing Comments





- With deal terms in the 5 – 10 year range, there may be instances where you start with one or two methodologies and end with another.
- The key is understanding the constraints by the various business areas of your deal to craft the right structure for your customer.
- Goal should always be to create a pricing structure that will work for the customer throughout the deal term

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