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Pricing Predictability in a Digitized Outsourced Environment

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Technological advancements in processes—including robotics, digitization, and artificial intelligence—are making some aspects of outsourcing agreements increasingly unpredictable. Tried-and-true methods of creating predictability through service quality and price certainty are being challenged by these models of predictive analysis and iterative change that underpin many of these outsourcing solutions.

Many industries view automation and digitization as critical to their growth strategies. Many financial services companies, for example, rely on advancements in artificial intelligence and robotics to bring new products and services to the marketplace. It is critical, therefore, that both buyers and providers of outsourcing services be prepared to address how these advancements, which create an ever-changing operational environment, impact expected pricing and efficiency outcomes.

Historical Context

Change and change management have always been important factors in any outsourced arrangement. When the concept of large-scale deals was in its infancy, contract length typically was anywhere between 10 and 20 years. Due to their lengthy duration and dependence on ever-evolving technology, outsourcing agreements have always been designed more like constitutions than contracts of absolute certainty because the parties had to anticipate future events at the time of contracting.

To address the forward-looking nature of outsourcing agreements, the parties created robust provisions that controlled how the parties addressed changes in the environment. Also known as “change control,” these provisions create rules for how changes to the services and/or the contract would occur.

Over the years, change control became synonymous with a process to negotiate an increased price for a requested or required change. In many instances, these price increases were justified: If the parties had agreed to a certain scope of services for a certain price, and the buyer wanted to modify that scope, then the provider could rightfully ask for an increase in price, especially if the modified scope would result in increased effort by the provider. Outsourcing buyers would argue that, if the provider can perform the modified scope with the same resources, then no price increase was warranted. Issues of resource allocation and modified pricing for additional or changed scope have always been a point of contention.

The New Paradigm: Contracting for an Environment in a Constant State of Change

Change control provisions primarily address unforeseen modifications in service delivery. But what if we contract for change? Is it possible for the buyer to maintain price predictability while the provider maintains its profit margin? Business process improvements through robotics, digitization, and artificial intelligence are creating increased demand for new sourcing deals or restructuring existing deals as buyers seek new ways to streamline operations. Because these technologies are based largely on smart learning, environments that utilize these improvements will be subject to dynamic change, with the goal of creating efficiencies that result in operational savings to the buyer.

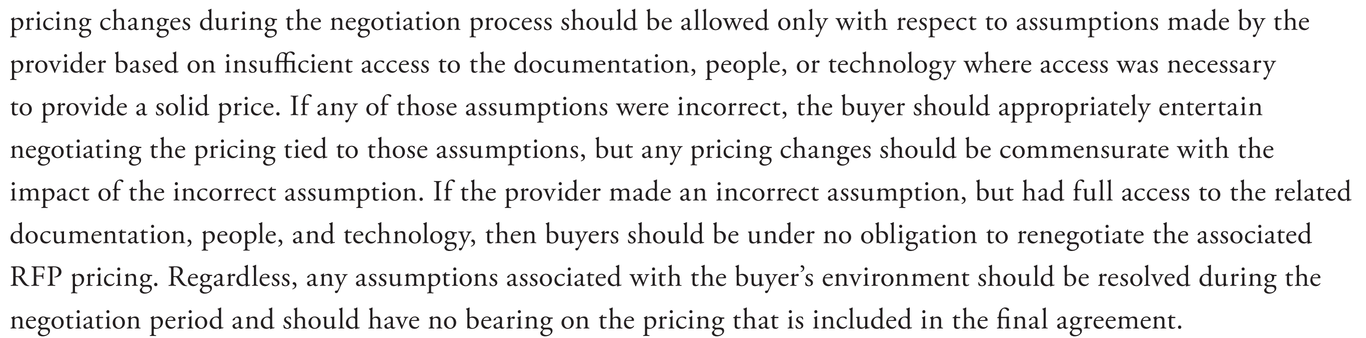
The problem in contracting for change is that the parties are attempting to provide predictability in an environment that is, by definition, uncertain. Providers want to make sure they retain their profit margins in the relationship, while buyers drive to have their financial expectations met, often including guaranteed cost savings. The two goals often are at odds. As we move further into this new phase of outsourcing, parties must be creative in finding methods to meet their respective economic objectives.

This divergence arises because artificial intelligence, which drives digitization and robotics, is based on the premise that the more times a process is implemented and analyzed, the smarter the process will become—leading to ongoing gains in efficiency. To win deals in a competitive environment, providers are forced to price the deals based on reasonably expected efficiencies. Providers will price as aggressively as possible—taking reasonable but not undue risk to win the bid. Aggressive price bidding by providers is nothing new, but the uncertainty brought about by artificial intelligence and iterative learning makes such practices more risky.

Buyers, on the other hand, expect that they will obtain the highest level of efficiency in their outsourced relationship even though the environment is in a constant state of change. When narrowing down to a single provider for final negotiations, buyers will typically insist that the pricing stated in the request for proposal (RFP) is not subject to change, basing their decision largely on that factor. For example, in its RFP bid, the provider may assume, in a deal priced on the basis of resource utilization, that in Year 3 of a five-year deal, it will reduce a particular resource by 30 percent. In the pricing bid, the total cost to the buyer for that resource will be reduced in Year 3 to reflect the decreased resource utilization. If the 30 percent resource utilization reduction is not realized—perhaps because the models used to predict greater efficiencies were wrong—the buyer will still want to be charged the price stated in the RFP (*i.e.*, reflecting the 30 percent reduction). Thus, the buyer's intent is to force all of the risk of operational uncertainty onto the provider. Providers, on the other hand, want to hedge against the uncertainty by seeking opportunities to modify the price if the efficiencies are not realized. Addressing these disparate needs in the contract can be challenging.

Even though providers will commit to pricing in an RFP, they will typically include a set of assumptions tied to that pricing. Those assumptions are the hedge against the promises of increased efficiency and declining prices. The assumptions almost always fall into two categories: those that are based on the existing environment of the buyer (*e.g.*, technology, processes, employee utilization, etc.) and those that are based on potential efficiencies the provider projects it can achieve. These two types of assumptions should be viewed differently.

For assumptions based on the buyer environment, the buyer's ability to insist on the RFP pricing may depend on how much due diligence the buyer allowed the provider to conduct during the bidding period. Requested



pricing changes during the negotiation process should be allowed only with respect to assumptions made by the provider based on insufficient access to the documentation, people, or technology where access was necessary to provide a solid price. If any of those assumptions were incorrect, the buyer should appropriately entertain negotiating the pricing tied to those assumptions, but any pricing changes should be commensurate with the impact of the incorrect assumption. If the provider made an incorrect assumption, but had full access to the related documentation, people, and technology, then buyers should be under no obligation to renegotiate the associated RFP pricing. Regardless, any assumptions associated with the buyer's environment should be resolved during the negotiation period and should have no bearing on the pricing that is included in the final agreement.

For assumptions based on potential efficiencies the provider projects it can achieve (*i.e.*, not based upon the buyer environment), buyers can insist justifiably that the provider stand by its RFP pricing. Between the buyer and the provider, the provider is in a better position to know what efficiencies it can achieve, even if the technologies and processes are still evolving. Accordingly, since the efficiencies are based on the provider's technology, processes, experience, and market knowledge, buyers can argue, justifiably, that the provider should assume the risk of not achieving those efficiencies. This, of course, places a burden on the provider to understand its capabilities and how those capabilities can impact the buyer environment. Absent wrong, misleading, or lack of information about the buyer environment that could affect the provider's efficiency projections, the provider is in the best position to bear the burden of unachieved efficiencies.

The key to mitigating risk on both sides is effective due diligence. In their RFPs, buyers should attempt to define their environments as fully as possible and provide providers all reasonable information related to the outsourced environment. The more information the provider has, the easier it is for buyers to reject pricing assumptions. Of course, it is impossible to provide perfect information, and providers are justified in stating assumptions where they must guess about the buyer environment. Reducing these information gaps will lead to a better, more precise pricing proposal that mitigates the risk on both sides.

Predictability in pricing outsourcing deals should be a goal for both parties. The more the provider can predict resource utilization, the better its services will likely be and the less the provider will be tempted to re-engineer its solution to meet its profitability targets. How the parties get to this level of predictability in an ever-changing environment starts with the RFP process and allowing a robust exchange of information in that process.

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