

RealPlay[®] Tool



Creating a Vested Agreement

Rule 4

Topic 21:

Pricing Model Test Checklist

Based on research with...



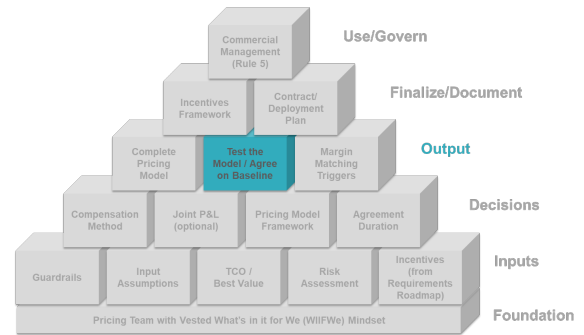
RealPlay[®] was created by Kate Vitasek, a faculty member of Graduate and Executive Education at the University of Tennessee's Haslam College of Business Administration. **RealPlay** takes role-playing to the next level. Instead of merely being assigned roles and a potential problem or situation to work through, **RealPlay** allows course attendees to take the material they have just covered in the course and immediately put the Vested theory and methodology into practice with their own situation, creating tangible decisions and deliverables essential for developing a Vested Agreement.

Pricing Model Test Checklist



Purpose:

Use the **Pricing Model Test Checklist** as a guide to help you create, test and validate your Pricing Model scenarios. Run these scenarios to ensure the Pricing Model's output is realistic, modeling best-case and worst-case outputs. You will also need to review and approve the testing results in a formal Gate Review.



Review:



*The slides below are from the online **Creating a Vested Agreement** courseware and are an excellent refresher.*

<p>Test the Pricing Model</p> <ul style="list-style-type: none"> Each party should consider a range of upside and downside scenarios to test the balance of fairness in risk allocation and any subsequent price adjustments Test the model by running scenarios to determine sensitivity, noting the impact that various assumptions and risk factors may have on the target price Use your Risk Assessment to provide guidance for testing your model 	<p>Testing Tips</p> <p>Revisit your assumptions based on the Risk Assessment and test the Pricing Model using your simulation model</p> <ul style="list-style-type: none"> What is your approach to spare capacity and the ratio of resources required to service the total capacity? What risk factors have been applied to the volume assumptions? Who bears this risk? Do you have accurate demand forecasting? What are the levels of predictability in volumes over time? Are there seasonal fluctuations, peaks and troughs in demand that can be smoothed over time?
<p>Testing Tips (continued)</p> <ul style="list-style-type: none"> Is there a cost and price differential for differing levels of service or standards of service? Are there any functional constraints? <ul style="list-style-type: none"> These might include local pricing considerations at different locations where the impact of losses in a highly competitive market is balanced against gains in less competitive markets Have you considered the impact of substitutions, new innovations, and cost improvement techniques over time relative to increases in firm orders? Is there an optimum point to review the price to ensure that multiple dynamic events affecting price do not detract from meeting the Desired Outcomes? 	<p>Testing Evaluation</p> <ul style="list-style-type: none"> Finally, test your assumptions and examine the results <ul style="list-style-type: none"> Do the results align with the four Pricing Model Design Principles? <ol style="list-style-type: none"> A Pricing Model (not a price) Incentives tied to Desired Outcomes Compensation for costs and risks in line with the six Guiding Principles Margin Matching to ensure continual alignment Are the results Win-Win? Are your assumptions regarding impacts of variables valid? Adjust the Pricing Model accordingly to set the baseline <p><i>Once you have a model you are happy with, you will have a target baseline price for a given set of assumptions and time span</i></p>

Deliverable and Resource(s):

► No formal Deliverable



RealPlay Exercise:

A key part of developing your Pricing Model is testing it. The parties should test the Pricing Model to determine the impact of various assumptions and risk factors. If you used a range of economic assumptions and parameters as you developed your Pricing Model, you should have set the stage to easily model various scenarios such as volume fluctuations, contract duration, and the impact of risks. A good testing analysis will educate everyone involved and will help facilitate sound business decisions.



Many teams find it easier if the Pricing Team does this exercise separately and comes to the Workshop with a DRAFT for the larger team to review, modify and ultimately approve.

Step 1. Pre-Work



- Ensure team members have completed Rule 4 – Topic 21 of the **Creating a Vested Agreement** online course.
- Before starting this exercise, you must have completed the Pricing Model, and your initial analysis as laid out in Topic 20 and the **Pricing Model Instructions**.

Step 2: Test your baseline

In this step, you will complete the initial testing of your Pricing Model. Start by testing with prior year actuals (if possible) to validate the model / sense check the accuracy of the model.

- Build baseline from actual cost build up
 - Ideal is a joint P&L that includes end-to-end cost of the business (Topic 17)
 - Use data input from TCO/Best Value analysis (Topics 9 & 10)
 - Verify the baseline covers the costs of processes identified in the workload allocation (Rule 2 Topic 5)
 - Service Provider costs (at minimum)
 - Buyer costs (if documenting a joint P&L)
 - Other third-party costs
- Test with prior year actuals to verify output
 - Adjust to compensate for differences in Scope / Workload Allocation between Buyer and Service Provider
- Test to budgeted spend and review gaps
- Verify profit/loss to expected returns based on budget volume estimates
 - Identify any breakeven points

Pricing Model Test Checklist



Step 3: Establish your test scenarios

How you test your Pricing Model will be as unique as the model itself. You will need to develop future oriented “what if” test scenarios. Use the Checklist below as a guide to help you develop your scenarios.



We recommend drawing on the expertise within the entire joint Deal Architect Team to think of scenarios. It may also be helpful to work with key operational or financial stakeholders to have them come up with “best case” and “worst case” scenarios as they will have a viewpoint that may be different than the Pricing Team.

Scenario Factors Checklist:

Develop best, worst and most probable case scenarios to test the impact risk and market fluctuations (e.g. what happens if volumes double? Or triple? Or there is a financial mandate where there is no volume for a month?)

- Each party should rank the probabilities of specific outcomes.
 - Margins
 - Volumes
 - Product or Service Mix
 - Rates
 - Cost of goods or services required
- Does your Pricing Model allow the parties to leverage value-generating elements while not focusing on bargaining on the sticker price solely to reduce spend?
- What is your approach to spare capacity and the ratio of resources required to service the total capacity?
- What risk factors have been applied to the volume assumptions? Who bears this risk?
- Do you have accurate demand forecasting? What are the levels of predictability in volumes over time?
- Are there seasonal fluctuations, peaks and troughs in demand that can be smoothed over time?
- Is there a cost and price differential for differing levels of service or standards of service?
- Are there any functional constraints?
 - These might include local pricing considerations at different locations where the impact of losses in a highly competitive market is balanced against gains in less competitive markets
- Do you need to consider the impact of substitutions, new innovations, and cost improvement techniques over time relative to increases in firm orders?
- Is there an optimum point to review the price to ensure that multiple dynamic events affecting price do not detract from meeting the Desired Outcomes?

Pricing Model Test Checklist



Step 4: Test your scenarios

Test your Pricing Model according to the scenarios that you have established. Examine the impact of the variables and adjust your Pricing Model as needed.

- Do your results align with the four essential Pricing Model Design Principles?
 1. A Pricing Model (not a price)
 2. Incentives tied to Desired Outcomes
 3. Compensation for costs and risks in line with the six Guiding Principles
 4. Margin Matching to ensure continual alignment
- Are the results Win-Win?
- Are your assumptions regarding impacts of variables valid?
- Have you made required adjustments to your assumptions based on your testing?
- Did testing identify any situations where you should perform margin matching? If so document them for the next exercise.
- Are all parties in agreement on how they will manage future fluctuations?
- Have you done a Monte Carlo Simulation type risk analysis where you examine multiple factors simultaneously? If not, do both parties agree why you did not do this?
- Test incentives payout and impact on buyer/supplier margin
 - Cost savings over baseline
 - Project based savings
 - High/Low transformation results
- Test any performance related payouts and impact on Service Provider margin
 - Fee at risk
 - Performance incentive



The best Pricing Models survive multiple attempts to “break” them. This often takes multiple test scenarios. For example, Dell/FedEx did 112 iterations of their Pricing Model before they got it right.

Step 5: Establish your baseline

Now test your highest probability assumptions and adjust the Pricing Model accordingly to set the baseline. Once you have a model you are happy with, you will have a target baseline price for a given set of assumptions and time span.

Step 6: Next Steps

As mentioned in Topic 20, we recommend that the Pricing Team proceed with Topic 22, and develop the Margin Matching Triggers to be used before presenting your work to the Deal Architect Team. This will expedite the approval process.

Contract Work

No formal contract work at this time.

Pricing Model Test Checklist



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