IT'S OUR OPINION…
OUTCOME-BASED CONTRACTS

FUJITSU

Not for **EVERYONE**

Outcome-based contracts work – in the right conditions

Outcome-based contracting is often seen as the holy grail of client-supplier engagement, but it's difficult to make it work – for both parties. Even when a contract includes the mechanism for contracting on outcomes (or even shared risk/reward), both client and supplier are often at a loss as to how to make it happen. It's our opinion that outcome-based contracts are achievable, but can only be successful if a number of pre-requisites are satisfied.

David Rosewell

WHO'S TO BLAME?

Imagine if installing domestic central heating was like contracting for IT services. The system might be delivered on time and budget, it might heat up the radiators and be able to work 24 hours a day. But would it deliver the outcome you want – increasing your house's temperature while lowering your bills? And if the problem was really lack of insulation (a complementary initiative), or not knowing how to work the timer (training), or using the wrong fuel (change management), would the supplier be to blame?

Outcome-based contracting (OBC) is meant to deliver business outcomes rather than IT systems. Examples of successful OBCs are rare, and some of those labelled as OBCs are in fact old-fashioned contracts based on pre-defined deliverables. In this paper we explore the challenges that clients and suppliers face and give some practical advice, based on our own experiences, on how to make OBC a reality.

A WIDENING GAP BETWEEN SUPPLIERS AND CLIENTS

Clients want business benefits

Clients increasingly seek a commitment from suppliers to deliver business benefits from IT investments. They need their suppliers to step up to the mark and work with them to deliver business benefits, not kit or systems.

The days when automation delivered immediate and direct benefits to a business have long since passed. The obvious manual processes have been automated and line-of-business systems have matured. Today, the path to benefits from IT is much more complex. The systems we now target enable business change which, in turn, contributes to realising the benefits. For example, customer relationship management (CRM) systems help the business to broaden and deepen its relationships with customers in order to maximise their value. We can only measure the success of CRM by interpreting the business's bottom line. The challenge for suppliers and clients alike is, therefore, to create a clear link between delivery of IT solutions and business outcomes.

Suppliers want to minimise their exposure

Suppliers traditionally reduce their exposure to risk by defining what they will deliver as accurately as possible. This habit makes them appear inflexible, but is reasonable given the number of high-profile project failures across all sectors in recent years. Suppliers suffer from bad publicity and lose business when their clients do not achieve the goals they set out to achieve – even when these were not explicitly part of the supplier's responsibilities. OBCs can amplify the supplier's risk by setting business outcomes as the measure of success, but failing to take into account the factors over which the supplier has no control. So, for example, if a lack of training or a failure to alter a business process leads to a system not being used, the supplier is punished. This really is a lose-lose situation.

THE WORDS MAY SOUND SIMILAR…

There are important differences between contracting on inputs, outputs, service levels and outcomes, although some contracts are hybrids.

Input-based contracts

Also known as time and materials contracts, you pay the supplier for the effort put into the work; for example, an advisory service based on a daily rate. From the client perspective this is flexible, but there is a lack of certainty about what will be delivered and how much it will cost. For the supplier, this type of contract offers low financial risk but often relies on named individuals and is difficult to 'value price'.

Output-based contract

Also known as fixed price contracting, you pay the supplier for the deliverable or product; for example a project-based service such as application development. The client has certainty of cost and ownership of the end deliverable and the arrangement is moderately flexible. The supplier has moderate risk, freedom to determine how to deliver and the potential to price for value, but needs to include contingency.

Service contract

Also known as managed service or outsource, here you pay the supplier to perform a service to the standards defined by a service level agreement (SLA); for example an IT desktop managed service or an HR service centre.

The client has certainty of cost and ongoing service delivery. For the supplier, costing is complex although there is the potential to charge by volume or number of transactions.

Outcome-based contract

Here you pay the supplier for the realisation of a defined set of business outcomes, business results or key performance indicators; for example improvements in the productivity of call centre staff or increased speed of staff recruitment. From the client perspective there is a lower risk that the contract will not deliver the desired outcomes, but it requires commitment to change and a partnership approach as well as alignment of objectives. For the supplier, there is a high risk but potentially higher reward, and a similar requirement for alignment of objectives.

Is outcome-based contracting the same as shared risk/reward? Not necessarily. Shared risk/reward can be applied to input, output and service-based contracts, for example by tying some portion of the payment to achieving a specific milestone. OBC is therefore a form of shared risk/reward, but not all shared risk/reward contracts are outcome-based. Another term, which has been used extensively in the construction industry, is gainshare. This is where a number of parties receive a financial incentive for performance improvements. Gainshare can apply between a client and supplier, between partners and between an employer and its employees. It is a form of shared risk/reward and can be applied to different contracting models, although it is most often associated with open book contracts.

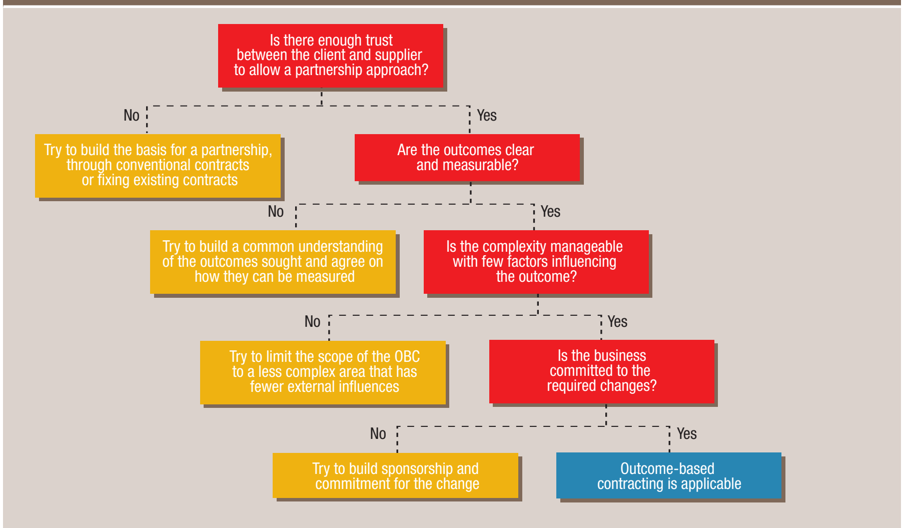
OBC WILL NOT WORK IN ALL SITUATIONS

Trying to apply OBC to the wrong type of project or in the wrong context is a recipe for disaster, and there are some key situations where OBC should be avoided.

OBC will fail if there is a lack of trust between the client and supplier, either because it is a new relationship or an existing relationship that is experiencing problems. In particular, moving to an OBC is not a way to fix a poorly performing outsourcing contract.

If the outcomes sought are unclear then the contract will be very difficult to agree and almost impossible to enforce. A lack of agreed mechanisms for measuring the outcomes will make an OBC impossible to run. An OBC will be particularly challenging if the outcomes are highly qualitative; for example a change in staff perception.

DECISION TREE FOR OUTCOME-BASED CONTRACTING



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OBC IN ACTION

One of our airline customers needed to cut its IT costs.

However, the costs weren't aligned with business processes and it was almost impossible to tell how IT spend related to sales, seats or profits.

The answer became obvious: re-structure IT so that it relates directly to the business and write a contract for the real world that links IT costs to business performance.

So the client and the supplier's success are entwined.

If the client misses a take-off slot it costs a lot of money to reschedule. If we caused that failure, we share the cost of re-scheduling.

If an OBC relates to a highly complex situation with many success factors, then the client and supplier will be forever debating whether the measurements are valid. For example, outcomes may have been determined by market changes or competitor activity, rather than the efforts of either client or supplier.

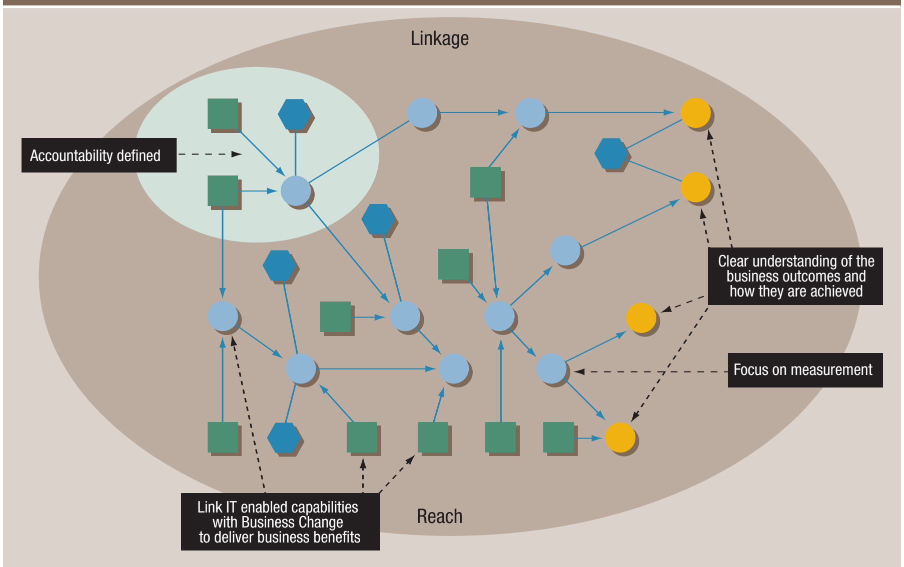
Lastly, a lack of business buy-in and commitment to change will mean that the desired outcomes will not be realised. For example, if there is a lack of appetite to change incentive schemes then staff behaviour will not change.

KEY PRINCIPLES FOR SUCCESSFUL OUTCOME-BASED CONTRACTS

Create a clear mapping of the outcomes

Client and supplier must share a clear, shared understanding of the outcomes they are jointly seeking. Whilst there might be a temptation to start building spreadsheets to track goals, we recommend a visual representation showing the overall programme of change necessary to deliver the outcomes. This representation, which we call an outcome roadmap, shows the desired business outcomes, together with the linkages between the initiatives and the intermediate outcomes. Most importantly, it articulates the assumptions and dependencies that impact the outcomes.

AN OUTCOME ROADMAP CAN HELP TO CLARIFY A COMPLEX SITUATION



The outcome roadmap makes the potential complexity of the tasks ahead clear to both parties. It creates an objective boundary or scope for the relationship and a mechanism for identifying and agreeing both outcomes and the conditions needed to realise them.

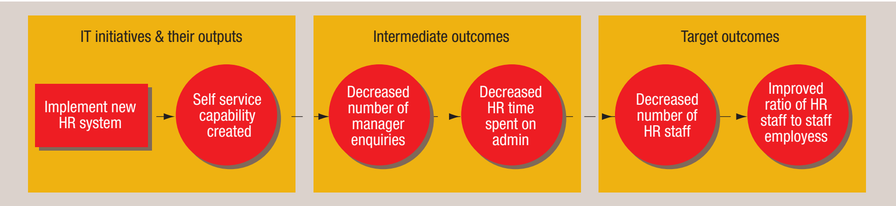
Focus on intermediate outcomes, rather than target outcomes

When people consider outcomes, they tend to think about target outcomes such as increased shareholder value, increased market share or increased margin.

When considering OBC, this focus on the target outcomes means that the supplier is, quite understandably, very unwilling to contract for the delivery of these types of outcomes as they are usually way outside of its control. The usual consequence is that the discussion reverts to an output-based contract focussing on deliverables, unless the parties are willing to consider a joint venture or special-purpose contracting vehicle.

We need instead to focus on intermediate outcomes, such as increased staff productivity, decreased time spent on manual activity, and so on. These intermediate outcomes fall part way between the capability that is being delivered and the target outcome, and therefore the supplier has more influence over them. In addition, the client is still wholly focussed on the target outcomes without the supplier seeking to interfere with strategic business decisions.

SIMPLIFIED OUTCOME ROADMAP SHOWING INTERMEDIATE OUTCOMES



An example of a successful OBC is an infrastructure managed service for an airline where part of our contract is tied to aircraft being ready to take off on time. Rather than the contract just being based upon the infrastructure working properly – for example ensuring that the printers for the boarding cards are operating within an SLA – we share in the achievement of an intermediate business outcome; aircraft taking off on time. We are not being measured on a target outcome for which we cannot realistically be called to account, such as increased profit of the airline or shareholder value.

Measure leading indicators of success

It's no use running your OBC and measuring the outcomes at the end of the contract or just before the payment milestones. Both parties must measure the leading indicators to ensure that the outcomes are on track and take corrective action if they drift. For example, in one of our healthcare contracts, the usage of the IT system by the business to process records, a measure known as volumetrics, is a leading indicator of whether the end outcomes will be achieved.

Ensure that the contract is flexible

Even with conventional contracts, problems can occur if a contract is too inflexible; for example where changing business priorities require a different set of services, deliverables or timing. With an OBC, the very nature of the contract is about the business and so there are likely to be changes driven by the market, competitors or customer behaviour. Neither party wants to be stuck in a contractual vehicle that is not delivering results. The contract should allow the scope to flex by mutual consent in order to ensure that the right outcomes are still being sought and that the targets are still achievable.

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CHECKLIST
Create a clear mapping of the outcomes
Focus on intermediate outcomes, rather than target outcomes
Measure leading indicators of success
Ensure that the contract is flexible
Ensure that the business is committed to the required changes
Ensure that the contract is not purely technology focussed
Focus on value and not cost
Governance should be business driven, not just legal

Ensure that the business is committed to the required changes

When the supplier and client contract on outcomes, they must ensure commitment from the business areas that own the outcomes (and therefore are affected by the changes). This commitment starts at board level but must permeate to all levels of the organisation. It includes committing the resources needed to participate in the programme and making the changes required to get the most out of the system being delivered. While commitment is required for a conventional programme or contract; it is the very foundation of an OBC and must be written into the contract.

Ensure that the contract is not purely technology focussed

With OBC, the delivery of IT capabilities is only the starting point of business change. In order to realise the intermediate outcomes, changes are required to people, process and structure. The initiatives to deliver these non-technology changes might be the responsibility of the supplier or the client, or may be delivered by joint teams. The key consideration is to ensure that all necessary actions are captured and the associated dependences and responsibilities defined and agreed.

Focus on value and not cost

While cost reduction is clearly a business outcome, most IT enabled change is designed to deliver much more. For example, shared services initiatives are often perceived as ways of saving money, they can also create value, perhaps through better customer experience. Therefore, while an OBC may include an element of cost reduction it is important to look to the wider value to the business, not least in positioning the contract as a positive, holistic vehicle rather than a hunt for savings.

An example is one of our local government contracts where the agreed outcomes include the speeding up of processes and increasing customer service, as well as reducing IT and accommodation costs. A specific outcome to which payment was tied was speeding up the procurement process and reducing the time taken to process and approve an invoice.

Governance should be business driven, not just legal

Any contract requires effective governance to deal with changes over its lifetime. With an OBC, it is important that the contract governance includes business representatives and not just the commercial department and lawyers. When the outcomes are measured, it is essential to ensure that any variation in results is put into the wider business context and does not immediately end up in court. In this way appropriate decisions can be made to ensure both parties are successful.

WITH CARE, OUTCOME-BASED CONTRACTING IS ACHIEVABLE

Clients are asking for OBC and while some suppliers are willing, others are running scared. In addition, some of the clients who are asking for it (or being encouraged to by government initiatives) are not entirely clear how to address it. With the right approaches, OBC can be made to work but requires a genuine partnership between client and supplier, a clear articulation of the outcomes sought, insulation from external factors and, most importantly, a commitment to change by the affected business areas.

Whose **OPINION?**

DAVID ROSEWELL

David leads the value governance practice in business consulting. Based in London, he specialises in getting public and private sector organisations to think about ‘the why’ as well as ‘the what’ to ensure the delivery of successful business outcomes. He enjoys the great outdoors and can often be seen walking up hills, providing there is fine wine, a decent meal and a comfortable bed at the end of it – a night in a tent not being a desirable outcome.

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YOUR OPINION

David would welcome your comments by email david.rosewell@uk.fujitsu.com or at uk.fujitsu.com/opinion

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