

Pricing Models in Outsourcing

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Abstract

Along with the globalization of Information Technology (IT) – related work, IT outsourcing has evolved to become mainstream in many organizations, both large corporations and startups alike. Such a labor arbitrage strategy is being increasingly exploited by many organizations through partnerships, joint ventures, captive operations, etc. to establish sustainable competitive advantage. Such an approach helps decrease costs, improve delivery, and access a broader talent pool of skills, etc. towards developing price and performance effectiveness. As competitive forces impinge on business entities, managers are increasingly re-structuring their organizations with an eye on achieving or maintaining competitive advantage. Despite the variety of benefits outsourcing bestows upon an organizational entity, pricing plays a predominant role and is often central to a strategic outsourcing decision - the primary objective of most outsourcing engagements is the achievement of some degree of cost savings. Although many articles have appeared on outsourcing, few have extended the discussion beyond simple cost benefit analysis and actually addressed costs and possible contract structures that accompany an outsourcing engagement. Hence, contracts are designed around pricing models, which shall be explored in detail.

Outsourcing contract models

Contract forms are usually equated to cost models in normal outsourcing practice. The different cost models currently employed are:

1. Staffing model
2. Fixed price (FP) model
3. Fixed-Price Contract With Economic Price Adjustment (FP EPA) model
4. Fixed price plus incentive (FPI) model
5. FPI Successive Target (FPI ST) model
6. Cost Reimbursable model
7. Cost plus Fixed Fee (CPFF) model
8. Cost plus Incentive (CPI) model
9. Time and Materials (T&M) model
10. Time and Materials (T&M) model with a cap
11. Consumption-based pricing model
12. Profit sharing model
13. Incentive-based pricing model
14. Shared risk-reward pricing model

1. Staffing model

The staffing model refers to the process of staffing or contracting of resources by the outsourcing organization from the service provider. The driver for such a model is the lack of sufficient resources or skills in-house that are required for a successful project completion. In this model, the outsourcing organization leases or contracts a specific number of resources for a specific period of time from a supplier i.e. the service provider. The service provider supplies the required resources based on an agreed upon rate for the duration of the project or on an as-needed basis. In this model, the contracted resources are usually located at the client site. Therefore, this model assumes that the client provides the necessary infrastructure for the resources to work on site.

The advantage with this model is that the project control always rests with the client. The contracted resources work under direct supervision of the client, hence closer monitoring and productivity depend largely on the client. This model allows for higher agility as the clients could progressively add or reduce resources, thereby maintaining absolute cost control. Even though this model has several tactical advantages, it has strategic limitations - the contract resources belong to the service provider, hence it is impossible for the client to build long-term competencies and capabilities with external resources.

2. Fixed price (FP) model

A fixed price model is also called a Lump Sum model and is an ideal pricing mechanism for projects with a clear scope, established project management methodologies, and a stable set of requirements. The teams at both, the client and service provider organizations have a good grasp of project requirements, have established a conducive working environment, are aware of each other's skills and capabilities, etc. Hence, the service provider furnish extensive amount of details on how the project will be executed before project kick-off. In this model, the requirements are so clear that periodic deliverables at agreed upon timelines (milestones) could be expected. Managing fixed price projects required a lot more professionalism, as the project risks are borne entirely by the service provider. Hence, scope creep and scope changes are difficult to undertake without incurring extra costs or reduced profits. Rigorous project monitoring and control, quality assurance (QA) and control (QC) and cost control are critical in executing fixed price projects.

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The service provider may setup payment terms with the client at periodic intervals or when milestones or intermediate deliveries are achieved. In this case, a fixed percentage of the total cost is paid at each interval through the course of the entire project life cycle.

In this model, the service provider contractor must take extra effort to ensure that they have covered their costs and could make a comfortable profit on the entire transaction. As the service provider assumes all the risks, such as increasing costs, covenants for nonperformance, or other issues, they usually builds in the extra cost of risk management into the contract price.

Fixed price contracts are most suitable for long-term projects and those that have a high value to the outsourcing organization.

2.1 Fixed-Price contract with Economic Price Adjustment (FP EPA)

In this type of fixed-price contract, provisions exist to accommodate adjustments to the stated contract price necessitated by contingencies triggered due to upward or downward movements of some macro-economic indicators. These economic price adjustments are of three types:

1. Adjustments based on established prices
2. Adjustments based on actual costs of labor or material
3. Adjustments based on cost indices of labor or material

2.1.1 Adjustments based on established prices:

Price adjustments are based on price divergence i.e. upward or downward price movement of specific items or contract items

2.1.2 Adjustments based on actual costs of labor or material:

Price adjustments are based on divergence i.e. upward or downward movement of labor or material costs that arise during project execution

2.1.3 Adjustments based on cost indexes of labor or material:

Price adjustments are based on divergence i.e. upward or downward movements in labor or material cost indices identified in the contract

A fixed-price with economic price adjustment contract is used when:

1. Serious doubts regarding market stability or poor labor conditions exist for extended time period during which the project is implemented
2. Contingencies could be clearly identified and covered separately in the contract price

2.2 Fixed price plus Incentive (FPI)

Fixed price plus incentive contracts are another popular form of fixed price contract. The main difference in this model is that the outsourcing organization i.e. the buyer of outsourced products or services includes an incentive or bonus for achieving some metrics important and relevant for the outsourcing organization. These metrics may include performance criteria, such as early completion, delivery that exceeds the scope specified in the contract, etc. Hence, it is mandatory that these metrics are clearly articulated in the contract so both parties understand the terms and conditions.

An FPU contract contains at least the following basic elements, which are negotiated at the outset:

1. Target cost
2. Target profit
3. Price ceiling
4. Profit Adjustment Formula (PAF)

Upon delivery, final costs and contract price are re-negotiated and using the profit adjustment formula. If the total project costs are less than the expected target costs, then the overall profit is greater than the expected target profit. On the other hand, when the total project cost exceeds the expected target cost, the final profit is less than the expected target profit, or may even result in a net loss. If the total project cost exceeds the price ceiling, the service provider absorbs the net difference as loss.

These contract types are most desirable in cases where it is pertinent for the service provider to assume some cost responsibility. It is also suitable when a target cost, target profit, and Profit Adjustment Formula could be negotiated at the outset.

2.3 FPI Successive Target (FPI ST)

An FPI ST model is similar to an FPI contract in most aspects. However, the only difference between these two models is that the FPI ST contract allows one or more adjustments to the target cost and profit values during the course of project execution. Such a contract is used when FPI contract cannot be used because realistic target costs and profits cannot be negotiated during the project kick-off.

An FPI ST contract adjustment could be done upfront or retroactively, giving rise to two further costing models, namely:

1. FP ST model with forward price re-determination

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2. FP ST model with backward price re-determination

An FPI ST model with forward price re-determination consists of two components:

- An initial fixed price for a certain initial duration during project start
- This period is followed by a period of prospective price adjustments or re-determination at time intervals identified in the contract

An FPI ST contract is used in situations where it is possible to procure commodity products or services at a fixed price for an initial foreseeable period, but price movements during subsequent periods make it impossible to fix prices upfront.

An FPI ST model with backward price redetermination contract consists of two components:

- An initial fixed price for a certain initial duration during project start
- Backward price re-determination within the ceiling after project completion

Price revision, in this model, also takes management effectiveness, innovation and ingenuity into consideration after the project is completed. This contract type is suitable for situations where a fixed price contract cannot be established because of contract size and short project duration that makes the use of any other contract type impractical.

3. Cost reimbursable model

In cost-reimbursable or cost-plus models, the service provider is compensated for the expenses incurred, up to a prescribed limit and an additional balloon payment to allow for some profit. Cost-reimbursable model differs from fixed-price model in that the service provider is paid a compensated to the extent prescribed in the contract, regardless of the nature of expenses incurred. However, in a fixed price model, the service provider is forced to deliver upon commitments within the limits set in the fixed price agreement.

Hence, in the cost reimbursable model, the service provider has little or no incentive to control costs as they are charged back to the client. Cost reimbursable contracts carry the highest amount of risk to the client organization, as the total costs cannot be predicted in advance. To avoid discrepancies, an estimate of total cost is established a priori to establish a ceiling, on the total costs the service provider may incur without further client approval and to ensure that the service provider may exceed this limit at its own risk. Under the cost-reimbursable contract, the service provider agrees to provide its best effort to deliver the required effort within the set ceiling limit.

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Cost reimbursable contracts are used when there is a lot of uncertainty regarding the project, when a large investment must be made in the project well before completion of the project, and when there is a high amount of risk.

3.1 Cost plus Fixed Fee (CPFF)

The cost plus fixed fee model permits the service provider to charge back all costs associated with project performance to the outsourcing organization and to take an agreed upon fixed fee upon project completion. The fixed fee portion is how the service provider makes money on the deal. In this form of contract, the fee is almost always fixed, but the costs are variable. Hence, the service provider does not necessarily have a lot of motivation to control costs with this type of contract. The only motivation to complete the project is driven by the fixed fee portion of the contract.

A CPFF contract may take one of the two basic forms:

1. CPFF completion contract
2. CPFF term contract

3.1.1 The CPFF completion contract

This form of contract requires the service provider to deliver a specific product or service delivery within the estimated cost as a condition for earning the fixed fee portion of the contract. However, if the service provider cannot deliver the scope within the estimated cost limits set in the contract agreement, the client may mandate the service provider to complete the entire scope without any increase in the fixed fee part, which eventually decreases the service providers' overall profit margin.

3.1.2 The CPFF term contract

This form of contract obligates the service provider to allocate a specified level of effort defined in the Service Level Agreement (SLA) for a specified duration. If the client considers the service provider's performance satisfactory, then the fixed fee is paid at the end of the contract term rather than at the end of the entire project. Further contract renewal is subject to cost and fee revisions based on performance baselines.

3.1.3 Cost plus incentive (CPI) contract

The cost plus incentive model is very similar to the CPFF contract in that only an incentive is added to motivate the service provider exceed the performance criteria laid out in the contract. The measurement criteria for evaluating performance must be clearly articulated in the contract and ratified to by both parties.

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The incentive may be calculated either as a specific percentage of the total project cost or by some other metric that compares estimated project costs to actual project costs. CPI contract is the riskiest of all contracts for the client organization because it cannot predict or the service provider cannot guarantee what the total final costs will be. Furthermore, since the profit to the service provider is a specific percentage of the total project cost, there is absolutely no incentive for the service provider to optimize costs or operations.

4. Time and Materials (T&M) model

Time and Materials (T&M) model is a popular pricing model typically used IT Application Development and Maintenance (ADM) projects that span a long period of time. Also referred to as Cost and Materials (C&M) model, this contract type requires the service providers to bid for the project based on client project requirements, depth of scope, amount of work and degree of coverage (scope and time).

Usually, work is done at the client organization's premises. The client project team is responsible for clearly defining the project scope, and overseeing the development process. Hence, it could be correlated that greater the definition of project requirements, the less time is wasted in re-work, so shorter will the project execution be, which implies considerable savings for the client organization. On the other hand, poor definition causes re-work, which in other words leads to increased costs and de-motivation for both, the client and service providers' employees. Hence, it is pivotal that the project deliverables are continually verified and validated, project continually monitored and controlled for any form of slippages, consistent and clear communication guidelines established, governance and escalation mechanisms put in place. Furthermore, the contract elements need to be clearly defined and agreed upon by all parties.

The service provider and the client organization may agree upon an hourly, daily, weekly or monthly rate for the project resources. This billing is based on the overall educational levels, skillset and relevant project experience. It is also possible to use a single blend rate i.e. one agreed upon rate for all resources involved in the project. As the blend rate basically levels billing, the service provider may internally use some standard resource allocation model to decompose, determine and map the resources required by the project. It is essential that the service provider communicate the decomposition and resource allocation model to the client organization to help the client understand the skill levels of the resources allotted to the project under its supervision.

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For effective project execution using a T&M model, the client organization should put in place strong project management teams and methodologies to monitor and track the project's progress on dimensions of schedule, scope, cost, quality and productivity. It is also mandatory that the client project teams tightly manage dependencies so that any costly lead or lag times (slack) could be avoided and resources' idle time could effectively be reduced.

The advantages of T&M model lie with the fact that skilled resources are locked for the entire project duration, so competencies and skills can be built over the time. This model bestows the client organizations with the additional flexibility of progressively adding or reducing head count over time to adjust to the changing project demands. Furthermore, management by metrics (MBM) or management by objectives (MBO) during the different IT development phases provide better insights into the cost structures and returns of using this model.

4.1 Time and Materials (T&M) model with a cap

The T&M costing model with a cap is an extension of the T&M model. In this case, an upper limit or cap on the costs is imposed to prevent uncontrolled cost escalations in an outsourced project. It is worthwhile to impose such restraints because it helps to ensure that the project benefits lie within budgeted cost expectations.

Even in case of T&M contract with cap, it is a prudent practice to conduct a pre-award audit of the service provider's accounting system to ascertain whether system could properly segregate direct and indirect cost from other overhead costs.

5. Consumption-based pricing model

This is a highly dynamic model in which the costs are allocated based on actual resource usage. This model is highly suited for outsourcing organizations that have to contend with issues, such as service provider productivity and variable demand. This model is well suited in situations where the fixed costs could be shared across many customers. Consumption based pricing delivers substantial productivity gains and makes cost structure analysis and adjustments relatively an easy task. Furthermore, this model converts capital expenses into operating expenses.

Despite these merits, this model requires a fairly accurate prediction of demand so that service providers could adequately provision their resources. Furthermore, for low transaction volumes, the unit price of an individual transaction may be prohibitive. Besides, due to the changing

demand pattern, it is a challenge to predict annual growth rates. From the service provider's perspective, the service provision costs could be directly attributed to the services delivered as measured in terms of resource units. The service provider also bears the risk that the resource units consumed are less than that required to break even and will not thus be able to cover fixed costs. These costs are then passed on to the client, who bears the now inflated prices so that the service provider could cover its fixed costs and make a tidy profit on top.

6. Profit sharing pricing model

The profit sharing pricing model is an outcome-based pricing model. This framework is based on incentivizing and rewarding the service provider for increasing the overall value delivered to the outsourcing organization beyond what is contractually expected from the service providers. Much of the value is deriving from the service provider's expertise and contribution. Such overall economic value addition is typical of strategic partnerships and alliances outsourcing models. This model is highly unsuited in condition where cost savings are the main fulcrum of an outsourcing engagement. Typically, customers seeking this contractual model do so because they rely on specific expertise from their service providers. These customers, hence, expect dramatic business improvements, which are typical outcomes of the transformational outsourcing model.

This model encourages and empowers service providers to engage in collaborative and creative problem solving as they work with the client organization towards achieving mutually beneficial business goals. This model, therefore, instills the service provider with a greater degree of freedom to best to achieve tactical and strategic business results. For a successful outcome, this model requires a high level of trust to exist between the participating organizations, equal distribution of risk and reward, and significant upfront investment. In general, the profit participation is closely linked to the risk sharing. Typically the service provider, to the extent of its ability to influence the results, will adjust risk-taking.

An interesting feature of the profit sharing pricing model is that it is not the input that is rewarded, but rather the bottom line the client organization expects. Hence, this model differs substantially from other incentive based models.

7. Incentive based pricing model

In this model, bonus payments are made to service providers for achieving specific performance objectives beyond what is specified in Service Level Agreements (SLAs). This model builds on top of a traditional pricing method, such as T&M or fixed price.

Most outsourcing organizations understand how incentives could motivate and drive the intended behavior from service providers. It is important to understand that incentives, per se, do not change the service providers' utility function, but rather incentives maximize the overall outcome by changing service providers' constraints. The challenge is establishing the right incentive structure to motivate all the involved parties to direct effort that will help the client organization achieve its business outcomes. Hence, incentive based pricing also serves as a governance tool. It is, however, important to note that profit sharing and value sharing methods employed as incentives cannot be equated or enforced among all parties. It becomes, therefore, important to understand value-drivers and motivators among the service providers to set up the incentive structure.

8. Shared risk-reward pricing model

Shared risk-reward pricing model is a flat rate pricing structure in which additional payments are based on achieving specific stated objectives. Appropriate for enhancement and transformational sourcing. This model is usually employed in situations where the service provider and client jointly fund new product or service development. Under this constellation, the service provider and the client share the rewards for an agreed period of time. All participating organizations agree to monitor and evaluate the project in an objective and unbiased manner using standardized set of metrics applicable to all involved parties. In some cases, a third uninterested party may need to be brought in to serve as an arbiter in case of conflicts. Hence, this model resonates very well among customers with a degree of governance considered mature enough to facilitate joint venture or partnerships with service providers on strategic projects. It is, therefore, important that the client organization shares both upside or downside benefits with its collaboration partners.

Summary

In summary, an effective pricing contract is a basic component for continued long-term success in an outsourcing relationship. Success or failure in a relationship could often be traced back, in part to due diligence, or a lack thereof, in the underlying cost and pricing structures enumerated in the contract. A good pricing structure will create the required governance mechanisms that align interests of all stakeholders, fairly distribute risk, and cohesively manage expectations across all players in an outsourcing engagement. A misinformed contract only fosters mutual mistrust and leads to mismatched incentives, inefficiency, and unpredictable expenditures. Regardless of the pricing contract structure, the underlying principle of $\text{cost} + \text{margin} = \text{price}$ should be respected as a fundamental reality to contract and pricing. This ensures that the services are correctly priced and a fair margin for the supplier that aligns interests, while incentivizing quality and delivery. Both are necessary for a successful outsourcing relationship.

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