Sourcing & Vendor Relationships
Advisory Service
Executive Update
Vol. 7, No. 5

Update

# Pricing Models in Outsourcing Contracts:

## Options, Issues, and Solutions

by Sara Cullen

Early outsourcing deals typically reflected the fixed-price model, but today there are many more options. Choosing the right pricing model for your outsourcing contract can be a very difficult task. It must fit not only the predictability of your organization's demand for contracted services but the predictability of the underlying costs borne by the service provider as well.

This *Executive Update* describes the three basic pricing options for an outsourcing contract, along with the rationale, risks, and management issues behind them. The three basic options are: lump-sum fixed, unit-priced, and cost-based. Worth noting, however, is that pricing model combinations, or hybrids, are more common today than any pure form, particularly with experienced outsourcing organizations.

### LUMP-SUM FIXED

The lump-sum fixed-price model represents a single-sum contract (e.g., US $2 million per year to operate a call center). Fixed-price contracting can be effective when demand levels and the cost to supply services are both highly predictable — otherwise, the price will be anything but fixed.

The rationale behind choosing a lump-sum fixed-price model is primarily to lock in prices and thus obtain predictable and controllable costs; although some choose this option for the purpose of having a single-figure invoice rather than a complex array of charges. However, to obtain this cost certainty or this single sum, the organization often has to pay a premium, because a portion of the fixed price relates to the supplier's risk in terms of the volatility of the cost to supply.

Premiums are not the major drawback to this model, however. The foremost disadvantage is the inevitable misinterpretations between the parties over what is "in" and "out" of scope. In many cases, the quoted fixed price is rarely the one paid since service volumes fluctuate and controversial "out-of-scope" services attract additional fees. Consequently, this model is notorious for the need for adjustments. Since the service provider already locked in its remuneration, what the organization gets for its money is also locked in. If, for any reason, the service provider can make the case that work has been done "out of scope" (i.e., not within fixed-price parameters), then it will likely charge an additional fee.

Accordingly, the key to success for the organization when using this model is to ensure that there are explicit scope definitions as well as an explicit agreement regarding

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what constitutes out-of-scope work and its associated charges. When a schedule of rates for out-of-scope work is included in the pricing schedule, the model evolves to a hybrid form. It is rare for an experienced client organization using lump-sum fixed-price models not to adopt a hybrid in this fashion.

Even so, if the organization's requirements change, even if it is insignificant from the organization's perspective, such changes can require substantial price negotiations. Some of these changes may be captured in the out-of-scope price schedule, but since outsourcing contracts tend to be longer than most organization's planning horizon, the future can unfold in unpredictable ways. To solve this problem, organizations often make out-of-scope work nonexclusive, thus allowing for alternative service providers to be brought in if the current provider charges too much or is not the best provider for that particular need.

The most difficult obstacle with this model is price reduction when requirements fall short of the predicted volumes on which the price was based. For this reason, fixed prices are commonly "banded." That is, fixed-price bands are established for explicit volume ranges. Whatever band the actual volume falls into reflects the price paid, thereby granting some flexibility to the organization.

Furthermore, there are likely other price limitations, often found in footnotes within the supplier's bid, which can "unfix" the price. Some of these limitations include volume and capacity restrictions. Others often revolve around pricing assumptions such as the CPI (Consumer Price Indexes), foreign exchange rates, availability of resources, and so forth. Accordingly, explicit agreement as to what are all the limitations becomes a key management focus at the contract-drafting stage, and the organization's continuous forecasting against these agreed-upon limitations becomes a key management focus post-contract.

Lastly, organizations with lump-sum fixed-price agreements have found it difficult to "unbundle" lumped prices when attempting to assess cost drivers or benchmark individual work activity or asset costs. The need for underlying data then becomes important in this model. Thus, organizations that use the fixed-priced model typically require a report regarding the underlying breakdown of the invoice's single figure, if not with each invoice, at least on a regular basis.

## UNIT-PRICED

Unit-priced contracts charge a price per specific transaction unit (e.g., $3 per call). This is the utility form of outsourcing, whereby the organization pays only for what is used. The rationale behind choosing a unit-priced service is primarily centered on the ability to address fluctuating demand while obtaining volume discounts. Some organizations, however, choose this model because the services are charged back to a business division on a usage basis, thus requiring an invoice from the supplier itemizing each business unit's usage and respective charges.

To minimize the overall costs under this model, most organizations guarantee some sort of minimum base load regarding volumes or guarantee a minimum payment irrespective of actual volumes in order to cover the base permanent resources the supplier requires. This base often has a lump-sum fixed price, giving rise to a hybrid price model — the variable element using the unit price comes into force above the specified base volume. Otherwise, service providers are forced to charge a high unit price when an organization's demand is too unpredictable or has no underlying minimum requirement in which to cover the supplier's underlying fixed costs.

The main risk associated with this model is exceeding budget since resource supply can be viewed as being unlimited. This is particularly pertinent when there is pent-up demand or when the supplier is able to generate latent demand. For this reason, the organization's ability to forecast and manage its demand for the service provider's resources becomes paramount.

It is still far too common, however, to find that an adequate warning system for demand tracking and management does not exist within the organization. There have been many cases where the organization assumed the service provider would perform demand tracking and management on the organization's behalf, even though this was not made explicit in the agreement. Such organizations have suffered frustration when surprised by large but valid invoices, and even more frustration when the supplier provides a later quotation on performing demand management services as part of the contract. For this reason, unit-priced contracts often have a cap on demand, which limits how much work the service provider can perform before seeking approval from the client.

## COST-BASED

Cost-based, or cost-plus, contracts are set up so that the supplier can pass on its costs plus make provisions for profit via a percentage markup (e.g., cost plus a 3% markup) or a fixed management fee (e.g., cost plus $1 million per year). This approach has value when the demand needs to be flexible and the costs to supply are uncertain. However, this model has high overhead due to the need to verify that the "best cost" was achieved, particularly if the supplier's profit margin is a percentage of cost, which can motivate the supplier to increase costs in the absence of mitigating controls.

The rationale behind choosing a cost-based price is to have full knowledge of the service provider's cost. A further benefit is that the organization is able to retain a better understanding of operations. However, it's important to keep in mind that the model can bear high management overhead. Auditing of the supplier's cost is the norm here, and if the organization does not believe the supplier is doing all things necessary to keep costs to a minimum, this leads to further auditing of cost evidence. If the organization finds that the service provider should have been able to provide the services using a lower cost base, the organization can only redirect the service provider moving forward, not recoup past expenses.

Inherent in this model is that the service provider does not have an intrinsic motivation to reduce costs, particularly if it attaches a percentage markup over the cost base (for profit and overhead); in fact, the supplier is motivated to increase the cost base to increase earnings. As a result, the organization typically has to become involved in the supplier's business and instruct the supplier in lower-cost alternatives.

The model works best when the market price for a service or asset, or the hours required to perform the work, are well known by both parties, thus leaving little room for the supplier to take liberties that are completely "legal" (according to the contract) but are not in the organization's best interests.

## CONCLUSION

In the past two decades, outsourcing has moved from being a relatively straightforward concept to one that is a complex aggregation of multiple options and permutations — of which the pricing framework is just one of the many configurations that organizations need to get right and manage well. A price model that worked for a certain organization, with a particular supplier, may not be the best model for your organization. The pricing options presented here offer insight into the rationale, risks, and issues inherent in each of the different choices available, and what management must consider to make each work.

## ABOUT THE AUTHOR

*Sara Cullen is the Managing Director of The Cullen Group, a specialist organization offering consulting, training, and methodologies regarding commercial agreements. Dr. Cullen was a former partner at Deloitte, where she ran the outsourcing consulting division, and she received her PhD from Melbourne University in the field of outsourcing. She has consulted to 87 private- and public-sector organizations, spanning 51 countries, in 116 outsourcing projects with contract values up to $1.5 billion per year.*

*Dr. Cullen has written 25 publications, conducted many reviews for government, been featured in more than 50 articles, and presented in more than 100 major conferences, in addition to research with various universities since 1994, including Oxford, Warwick, and Melbourne Universities. Her in-depth knowledge has been globally recognized, resulting in reviews of outsourcing research for the* Harvard Business Review, California Management Review, *and the* European Conference on Information Systems. *She can be reached at scullen@cullengroup.com.au or visit www.cullengroup.com.au.*