Outcome-based contracting: Past, present and future

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Outcome-based contracting is seen by many customers as the Holy Grail of outsourcing. At its simplest, it involves the outsourcing supplier's charges being linked, in whole or part, to the achievement of defined business outcomes for the customer, rather than being based on input costs, such as labour, or outputs, such as transaction volumes.

Outcome based contracting is not new. It's been used in parts of the outsourcing industry for years, most notably manufacturing. Rolls Royce's "power by the hour" service - where maintenance charges are based on the number of hours in flight achieved by its jet engines, rather than on labour and parts - is the classic example of genuine outcome-based contracting.

So, although not a new concept, outcome-based models are gaining traction in other parts of the outsourcing industry, driven in part by recent economic conditions, and the desire of customers to derive more value from their outsourcing spend.

Evolution of contracting in action

The F&A outsourcing market provides a good illustration of how pricing models have evolved as the market has matured. In the first cycle of F&A outsourcings, suppliers typically charged based on the number of FTEs. This input-based model (which rewards inefficiency) has largely been replaced with an output-based model, where suppliers are paid based on number of transactions processed. Whilst transaction-based pricing is still the norm, most current F&A outsourcing contracts will involve an element of the supplier's charges being linked to achievement of pre-defined objectives that have a direct financial benefit for the customer, such as reduction in the number of customer debtor days, or processing of payments to obtain the benefit of early payment discounts.

Similarly, in mortgage and loan administration outsourcings, it is increasingly common for some of the supplier's charges to be linked to successful collection of arrears payments, and/or the reduction of the number of borrower accounts in arrears. Whilst the attractions to customers of outcome-based pricing are obvious, the model is not appropriate for all types of outsourced services. Where it is used, in order to deliver genuine success for both parties, it requires a change in approach and mindset by both supplier and customer.

Key ingredients for successful outcome-based contracting

Focus on those services which can directly influence business outcomes. As noted above, outcome-based pricing works well for many BPO transactions, where the supplier's performance can directly influence the achievement of pre-defined customer benefits. This is not always the case for IT outsourcing - such as application development and management services - where the outsourced services are often too far removed from business outcomes for the model to work, or where the supplier's performance is only one of many components in the achievement of the customer's business objectives. Identifying those services that can directly influence achievement of customer benefits is critical to a successful outcome-based model.

Objective performance measurement. Where an outcome-based pricing model is used, the business outcomes should be clearly defined in the contract, objective and capable of easy measurement (with the measurement metrics captured in the contract). If any of these are missing the model is unlikely to succeed, and there is a much greater risk of tensions and disputes arising between the parties during the deal's lifecycle. In practice, a contract which uses a combination of service levels, KPIs, and a limited number of well-defined business outcome measurements is most likely to deliver the desired results for customer and supplier.

Greater supplier control over service delivery. In an outcome-based contract, suppliers will generally expect much greater control over how the services are provided - including methodologies, tools and locations - so that they can adapt their service delivery models as appropriate to achieve the relevant business outcomes. This often means less emphasis in the contract on input-based specifications and definition of service delivery processes. This relinquishment of control requires a mindset change for customers, and can be a challenge for many customers whose natural tendency is to micro-manage service delivery. It may also raise regulatory challenges for customers in some sectors, particularly those in the financial services sector who are required to retain greater control over their outsourced services.

Understanding the customer's business. Suppliers will generally only assume the risks associated with an outcome-based model where they have a detailed understanding of the customer's business. That means having access to accurate, historic data about the customer's performance against the defined business outcomes, including costs and any factors that have influenced achievement of those outcomes in the past. This places even greater importance on the due diligence that the supplier must carry out pre-contract. The need to understand the customer's business means that outcome-based pricing typically works best where the customer and supplier have an existing relationship, or where the supplier has a track record of providing services to similar customers. In practice, this means that an outcome-based model is often most appropriate where an existing outsourcing relationship is being extended, or at the very least, following an initial baseline period during which data can be collected, analysed, and used to agree an appropriate outcome-based model.

Greater transparency and better governance. Finally, the supplier will need ongoing access to information about the customer's business performance during the term of the contract, including information about the customer's strategy, its business plans and product roadmap, and any other factors which may affect the defined business outcomes. This in turn places even greater emphasis on contract governance and relationship management. The governance structures used in input/output-based contracts are unlikely to deliver the transparency and visibility required, and these structures should be modified to provide the supplier with greater insight into the customer's business, including executive-level engagement on both sides.

Successful implementation of an outcome-based model requires realism and pragmatism from both parties and their advisors, careful planning and due diligence, genuine sharing of risk and reward, and transparency and trust between the parties. Whilst each of these success criteria come with their own set of challenges, outcome-based models, implemented in the right circumstances, can be an effective way of driving value and innovation from an outsourcing relationship.

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Industry Insight

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In recent years, as technology is increasingly seen as a business enabler and companies across all industries come under increasing pressure to provide more value within constrained budgets, a key focus for customers and their strategic partners has been how to drive better engagement and business outcomes – particularly where organisations are mature in their outsourcing lifecycle and looking to create more from their relationships. As a part of this, attention has also turned towards some of the issues arising under existing arrangements, such as a perceived lack of cooperation, sub-optimal management of interfaces, processes and behaviour, and limited innovation culminating in loss of value.

These experiences, together with an increased awareness of how different internal and outsourced activities can impact on business, has led to a focus on how companies can work together to find a mutual value point that drives better results and what contractual arrangements can best set the scene for this.

As a consequence, outcome-based contracting has received renewed attention with its focus on what outcomes the service provider can deliver and structuring payment around delivering the desired outcomes, rather than the prescribed activities and tasks - something the economist Levitt notes makes intuitive sense – "the customer really doesn't want a drilling machine, he wants a hole in the wall" and should get paid for that.

The focus of these types of contracts is therefore less about what the supplier is providing and more around contracting for the outcomes or broader business results the supplier is helping achieve, such as: measurable growth in a part of the business and/or effectiveness of a function; service or business process transformation generating better results; or, at its broadest, more satisfied end-users, customers or shareholders. To contract in this way outcome-based contracts typically have three key characteristics: a focus on business outcomes, instead of activities and tasks; the use of measureable performance indicators that are tied to the defined outcomes; and a pricing model that includes rewards and risks to help incentivise the achievement of these outcomes, with delivery against those outcomes determining the amount of fees paid.

While not without challenges, this approach can be of particular interest to an organisation's business process or technology function, providing a golden opportunity to build contracts that keep pace with technology trends and delivery models and allowing third party technical expertise to deliver real value to the business.

Challenges associated with outcome-based contracting

How to measure contract performance. Specifying business outcomes that are high level enough to achieve the benefits of outcome-based contracting but remain specific enough to measure is a challenge. This can be achieved by tying outcomes to measurable data and agreeing upfront how to best create a metric that indicates the outcome is being delivered. Creating mutual incentives like gain-shares or other payment mechanisms can also help to improve supplier collaboration.

How to share risk (of success as well as failure). Technology commercial/finance functions can be wary of suppliers after historic experience of poor performance - especially in long term contracts where threat of competition to an incumbent supplier is low. This customer attitude can also foster a lack of trust or willingness in suppliers to meet the challenge of delivering outcomes rather than outputs, resulting in contracts that focus on granular tasks and actions. Again, looking at how to explore sharing risk for delivering the agreed outcomes should be considered, whether by using gain/loss share, or other mechanisms and incentives, in order to drive good performance.

Understanding the business vision. Unless the business vision for the solution is understood, it is very difficult to articulate the outcomes that suppliers need to deliver, and can make quantifying performance measures difficult, as well as risking preventing suppliers from bidding due to lack of information, or providing very high prices to overcome knowledge gaps.

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Case study

__PwC__ worked with a large UK police force on an IT service improvement programme to make significant cost and efficiency savings without cutting police office numbers, and in parallel reduce neighborhood crime and boost public confidence in the services provided. Technology was a key enabler for delivering the strategy, and a technology infrastructure was needed that would underpin more flexible frontline policing and provide a consistent yet adaptable platform.

The existing ICT estate was provided by a prime supplier under a multi-year old ICT contract, and through the life of this contract the commercial and contractual arrangements, technical landscape and infrastructure services had become complex, expensive and not fit for purpose.

An IT outsourcing programme was launched which aimed to improve the costs and quality of services, and introduce a multi-supplier tower-based model. The commercial arrangements to achieve this were complex and the aim was to provide a commercial construct that provided a blend of input, output and outcome-based obligations to meet the police service's needs. PwC worked with the police service and put together an ICT services contract that blended these types of obligations.

In this deal, the master services agreement defined a broad construct of how suppliers would work together, alongside individual tower-based service agreements that contained the obligations for specific towers. This agreement included an incentive mechanism that focused on business outcomes, stipulating that each supplier contributes a proportion of their monthly service charge (together with a contribution from the police service) into an "incentive fund". At the client's discretion this fund could be awarded to a supplier in recognition of successful partnering, appropriate behaviors and delivery of the desired business outcomes. The intention of this contracting approach is to create a contract that truly focuses on the business outcomes rather than outputs.

While outcome-based mechanisms were part of the force's success in the programme, it is also important to acknowledge the major role that input and output-based requirements played in ensuring that mission-critical outputs were delivered on time and to the correct quality. For example, the detailed IT service requirements for the individual towers that specified which services would be delivered and when.

The police service's programme is considered a success, and is now on track to make year-on-year IT savings of over 25 per cent of run costs.