Outcome-Based Contracting in IT: finding the Holy Grail?

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INTRODUCTION

Outcome-Based Contracting (OBC) looks to many like the holy grail of outsourcing in IT: a way of driving tangible business benefits from all echelons of IT. It does this by attempting to link the commercial model of a transaction to a series of concrete business outcomes and objectives. For non-IT services, there are some interesting examples such as managing working capital costs by the way that accounts payable and accounts receivable functions are operated. However, examples are harder to find for IT.

At face value, the concept seems simple, but for IT-managed services and decades of sourcing history, reality is very different. Also, OBC is commonly confused with output-based models, which form the commercial basis of many sourcing transactions in today's environment, meaning few people really understand the sacrifices that both parties need to make in this environment.

For buyers, these sacrifices relate to relinquishing more control of the outsourced processes and technologies, giving the suppliers a much freer rein to operate and deliver. Years of conditioning and lessons learned have taught us to apply relatively strict levels of governance and oversight on outsourcing contracts, making this change harder to implement. For suppliers, the primary sacrifice is related to surety of revenue- with a fixed price contract, or one based on time and materials, it is clear at the outset of an engagement the level of revenue that will be generated. With OBC however, there are often many factors outside the direct control of the supplier which can impact the outcome, and ultimately impact the final supplier revenue. Suppliers therefore need to take on a higher level of risk.

The high-level benefit of OBC is plain to see, but what are the underlying benefits that make it so attractive for organizations? Despite being a concept that has been around for several years, many firms have not really embraced it, so why is it so hard to implement and what can be done to make it work? In this short article, we will explore these questions.

EXPLAINING THE BENEFITS

Efficiency

By letting suppliers focus on outcomes, they are free to determine how they structure their own delivery models. Therefore, market forces will generally push them to standardize and create economies of scale to drive down the unit cost of delivery.

Partnership

As suppliers are encouraged to focus on how they impact business objectives, they will strive to understand the business environment better and seek to offer solutions that fundamentally transform the business as a whole. This will come with greater emphasis on innovation, resulting in a mature relationship between supplier and customer.

Quality

Suppliers are motivated financially to put quality at the forefront of delivery without the risk of gold-plating their solutions. If suppliers consistently deliver quality services, it builds trust and reduces potential overhead required to remediate poor performance.

ARTICULATING THE CHALLENGES

With such attractive benefits, one might be forgiven for wondering why OBC isn't ubiquitous throughout the IT sourcing world. There are three key issues that must be overcome to successfully realize the benefits.

Demonstrating impact

Probably the biggest challenge in a non-isolated environment, is being able to draw an undeniable and demonstrable link from the IT function to strategic KPIs that measure business performance. It can be easier to do this across the application layer but can be a huge challenge at the lowest level of IT infrastructure.

Letting go

For OBC to work, suppliers need to be given a relatively free reign in the way that they deliver their services. This requires a certain amount of faith and trust, which, in our experience, is often difficult for customers. This is further compounded by the delicate balancing act within a customer organization to manage risk and instil control.

Aligning stakeholders

When we elevate these challenges up a level, we find that aligning the varying stakeholders across the client and supplier organization is hugely challenging. Typically, procurement, vendor management, finance and of course, IT, can be pitted against each other with sometimes conflicting objectives. Usually at the onset, there is optimism and enthusiasm for partnership and pushing OBC. However, in a typical outsourcing environment there can be many battle-hardened cynics. Convincing them requires a big change management initiative.

HOW TO MOVE FORWARDS

As with most change initiatives, there is no "one size fits all" solution to successfully implementing an Outcome-Based Contract. However, there are some clear steps that organisations can take to make progress.

Define the rationale

Before jumping blindly into OBC, take the time to agree the rationale for implementing OBC across all stakeholders. Usually in IT this is going to mean that the CIO, functional heads, procurement and vendor management are all aligned. While the potential rewards can be enticing for OBC, the investment effort is material, and therefore uniting everyone at the beginning is a key step.

Align what is being measured

Without a doubt, an essential but time-consuming activity is to identify the critical business objectives which the transaction is looking to influence, agree on how the underlying service will impact these and ultimately how the two can be tied together. Typically, we see that more business-facing services are better aligned with the principles of OBC, as the link between business objective and service is easier to highlight. In addition, taking the time to understand how a supplier organization works and is incentivized will prove useful towards understanding how they will likely respond to an OBC transaction.

Mobilize a change management initiative

Successfully implementing OBC requires a cultural change in the customer and supplier organization. More trust is placed in the supplier, rewards are offered for good performance and the supplier is seen as a driver for value, not a cost to be managed. Historically, we have found that organizations struggle to make this transformation without a concerted change management effort that transforms people's mindset.

As the outsourcing ecosystem continues to mature, we expect to see some inroads into the adoption of OBC models. In the future editions of *Compact*, we endeavour to elaborate on the successful implementation of adopting OBC models in the market.

Take the time to agree the rationale for implementing OBC across all stakeholders

About the authors

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