The CIO’s Supplier Dilemma: Outcome Based vs T&M Contracts

The project you signed off last year has seemingly been going to plan, then just weeks before launch date small cracks become gaping fissures and you find yourself confronting reality: the project isn’t going to deliver as planned.

When large sums of money and your personal reputation is on the line, there is not a more terrifying or isolating experience. But you are not alone. Of all large (> $10m) projects started just 10% are delivered on time, on budget and with required features. 38% are simply cancelled before completion or never used.

Hadley Baldwin has been wrestling with this challenge for 15 years: How does a CIO ensure projects stick to budget and deliver on time - or get them back on track when they slip?

Hadley has worked with several blue chip companies including Royal Mail, Marks and Spencer and HMRC to get projects implemented straight through to their successful launch. Through his extensive experience he has identified a key dilemma that a CIO faces and one which can make all the difference: Should I insist on outcome based contracts for my largest projects when everyone around me seems to want Time and Materials?

There are many reasons why others may want to get the project started with an input based Time and Materials (T&M) based supplier arrangement:

- The business might want to move quickly which is easier with T&M, at least to begin with
- The project team may not want to face the reality that there are gaps in their understanding of the outcome or requirements
- Procurement may find T&M easier to understand, negotiate and benchmark
- For the supplier, T&M is lower risk

In Hadley’s experience, however; insisting on outcome based contracts with suppliers is a battle worth fighting. In this article he shares his insights on how this key supplier choice will keep you from becoming one of the statistical casualties.

But first of all you need to work out exactly what you want your outcome to be...
Beginning with the end in mind – Define your project outcomes

At the start of a project, the number one concern of the CIO is usually gaining buy-in, acquiring the support of peers and bosses – and securing budget to make it happen.

An important consideration at this point however should be how to go about setting the project up to beat the ugly statistics. Gaining business case approval can be an important and exciting milestone… but without correct planning and supplier setup ahead of locking down the budget and timeline, the project is unlikely to be successful in the long run.

This is especially important when you consider the nature and scale of what failure looks like when a large IT project goes wrong. A study by Harvard Business Review broke down the overrun of 1471 IT companies to alarming effect.

The average cost overrun was 27%. However one in six of the projects was found to be a ‘black swan’. (term coined by Nassim Nicholas Taleb to describe high-impact events that are rare and unpredictable but in retrospect seem not so improbable) with a cost overrun of 200%, on average, and a schedule overrun of almost 70%.
The study concluded that ‘an unusually large proportion of projects incur massive overage’— that is, there are a disproportionate number of black swans. It is this risk that makes getting project management right such an important element of a business and why it is vital to know where you are going from the start.

Inadequate preparation prior to project approval will leave you with a project that’s not set up correctly. It may be that the approach has not been thought through or that the project is not grounded in clear scope, good governance and a strong confident team. Or it may be that the suppliers have been set up in a way that their goals and objectives become divergent with the client post contract award. The first step to good supplier set up is absolute clarity on the desired outcome.

“Fuzzy business objectives, out-of-sync stakeholders, and excessive rework” mean that 75% of project participants lacked confidence that their projects will succeed.” - Geneca’s survey of 600 people closely involved in software development projects found that even at the start of a project many people expect their projects to fail.

Clearly defining your outcomes from the start is a key way to give your project the best chance of success. ‘It’s a lot healthier to be thinking about the end and the outcome and not thinking about the next milestone where you get financial approval. That would be a hallmark of over-focus on getting funding and under-focus on getting the outcome. It would be one of the warning signs during the mobilisation stage that I would say people should look out for.’
Two different ways to work with suppliers

There are two ways to work with suppliers, one is to pay by inputs (T&M) and the other is to pay by outcomes.

Focusing on outcomes is particularly relevant when it comes to preparing for an initial contract award with suppliers. If most of the project budget will be spent on suppliers, having a clear approach to maximising supplier performance will be key to your success.

Getting a supplier involved from the outset is a good approach for a number of reasons. They often have:

- Worked with your competitors doing similar projects and programs
- Been through this process before, albeit from a supplier perspective
- Possess insight that’s useful to you, and are willing to share it because they’re hoping to sell you something

In an ideal world, you want to make the most of that insight while not trading away your competitive leverage or your control over your projects. So, for clarity:

Paying by inputs (T&M): you pay for the supplier team’s time and expenses as you go, meaning the costs are not fixed and the potential for them to spiral is relatively high. For the supplier there is a low risk as the cost and budget overruns described above are on the client’s dime. A delay will likely make the supplier more money! This is a common scenario where clients are over eager to move forward and hence do so before having fully defined the desired outcome.

Paying by outcomes: outlining an outcome with your supplier and agreeing an overall cost from the start, the risk is shifted to them. If the work takes up more resources than expected it affects their margins rather than yours. Another advantage of this is that it forces you to be very clear about exactly what you want and gives you valuable insight on how to get it. However, the overall objective here is not to simply move the project risk from client to supplier. It is to reduce the overall level of risk and ensure the risk that remains sits with the party that take effective action to manage it.

Paying your supplier by outcome is likely to drive two important behaviours, which will increase your chances of successful delivery:

- The supplier will drive your organisation to provide much more clarity and answer key questions on scope and requirements that might otherwise go unchallenged, this additional clarity increases the chances of success for all involved.
- The supplier will likely have a mixture of input and output based work across their portfolio and is likely to focus their best efforts and people on the projects where the most commercial risk lies, outcome based contracts.
The ideal scenario is at the outset of a project you can describe and write down what it is you need the supplier to do in a great deal of detail in a way that’s bound and contains what it is that you’re buying and what you want to buy. This allows you to compete that piece of business across a number of suppliers.

‘The trick is to do that as part of building your business case, so at the point you’re finalising your business case you’ve seen three or four supplier proposals come in to build what you want to build, and those inform your business case.’

Once your business case is approved, you can buy the best proposal that you’ve received, rather than building your business case first and then trying to deal with the supplier second. This way, suppliers can help you shape up what it is you need to buy. They can work up their proposals while you work up your business case. If your business case gets approved then the chosen supplier can mobilise quickly.

A survey by IBM of 1,500 change management executives found that only 40% of projects met schedule, budget and quality goals. One of the clearest reasons for this was ‘underestimation of complexity’ which was listed as a factor in 35% of cases. Establishing clear relationships with suppliers from the start is one way of teasing out and understanding complexities as opposed to being swept along by a false sense of simplicity. Being aware of the nuances of what you are planning to deliver before trying to make it happen will give you the best chance of actually doing so.

Whilst outcome based contracts offer many advantages, they do not guarantee that the contract will always work in your favour. There is still a chance that some suppliers will try to increase their margin by using cheaper labour or adding so many caveats into the contract that it puts all the risk back on the CIO. This is why long term supplier relationships come in so handy – the trust is already in place.

Making sure an agreement with a supplier is mutually beneficial is another way to make sure you get the best of their services and ensures sustainability.

‘It’s important to set up supplier relationships that are fair and equitable. You’ve got to expect your suppliers to make a profit the same way you’re going to make a profit. The bigger prize is efficiency and setting your supplier up to be able to work in a way where they do what you want and they get it right the first time. Because the worst case scenario is there’s lots of waste, and the supplier loses their profit margin, and you lose your ability to hit your budgets.

The win-win scenario is the supplier executes right the first time, they build you what you need or they provide what you need right the first time, therefore you hit your budget parameters and they make a sensible profit. That’s the ideal outcome.’
Supplier & client focus = win/win

A key factor in managing projects is to take the long term view all the way through to getting the benefits. Don’t lose sight of your purpose.

Unfortunately this is often not the case.

A study on 5400 large scale (>15M) IT Projects carried out by Oxford University in 2012 found that on average, large IT projects run 45 percent over budget, 7 percent over time, and deliver 56 percent less value than predicted.

Whilst the first two statistics are worrying enough, the third highlights an even more pressing concern. If a project deviates from its intended value it could end up becoming entirely worthless, no matter how much time and money have been funnelled into it. The study also found that 17 percent of large IT projects go so badly that they can threaten the very existence of the company, which indicates just how much can be at stake.

Whilst it is important to meet milestones or checkpoints, this should never be at the expense of the overall aim or vision. ‘Over a long 18 month to 3 year project, it’s very easy to lose sight of the benefits and focus on getting the platform or the product or the systems live… Successful delivery is about having a long term view and being careful in the trade-offs you make.’