Stuart van Rij

The price of predictability

FIXED-PRICE CONTRACTS ARE indeed a persuasive means of obtaining price certainty in ICT projects. There's nothing better than knowing in advance the numbers to plug into the business case or budget. However, there are limitations to the fixed-price model that can cause a project to become unstuck. Consider the following:

1. Too much or too little contingency

The supplier's appetite for both risk and winning the business will result in a contingency component to the fixed price. No surprises there. The issue is where the contingency is considerably high or low. If it's too high ... well, no one likes paying an unnecessary premium. If it's too low the supplier might lose money resulting in a difficult relationship and less than optimal performance (see our previous column "Beware the Winner's Curse", *CIO New Zealand*, December 2006 and January 2007 and at www.wigleylaw.com).

The obvious strategy for tackling a high contingency is to reduce the uncertainty to which the contingency is tied. This often means enabling adequate due diligence so the supplier can get to grips with your business. Jenny Mortimer, former CIO and now general manager, sales and consulting at Datacom, recommends an initial elaboration or requirements' gathering-phase (usually on a time and materials basis) to better understand exactly what work is required. This may well result in a better price for the later phases and a more affordable project overall.

2. Cost cutting could degrade quality

To increase its margin under a fixed price arrangement the supplier is "incentivised" to cut costs. That's all well and good provided they maintain the expected level of quality, particularly when unexpected aspects of the project put pressure on margins. Russell Turner, CIO of MetService, considers this one of the main issues with fixed-price contracts. Consequently, it's vital that a fixed-price contract has clear and comprehensive descriptions of the services and deliverables.

Generally, it's best to focus on the "what" more than the "how" in preparing these descriptions. A balance is also needed between the general and the specific, as too much specificity can result in unintended limitations. To help limit disputes around the fringes, consider providing that any specified services are deemed to include all of the services, tasks, and activities, etc. that are inherent or incidental to the provision of those services.

3. Unexpected changes could increase costs

Fixed-price contracts lend themselves to rigid management of scope by the supplier and, if margins are tight, excessive change control (i.e. death by a thousand cuts). When the inevitable changes occur the customer can find himself in the vulnerable position of being wedded to the supplier's solution with little leverage to negotiate an optimal change request.

In addition to capturing pricing principles and catering for predicted changes in the contract, you can increase your chances of a favourable change request by ensuring your fixed price is broken down into meaningful components (such as service categories, software licenses etc). Although the vendor may be concerned about "cherry picking", it's valuable information if you need to re-jig the deal down the track.

4. Half-baked assumptions

Inevitably the fixed-price contract will include a number of assumptions. However, we often find that these contracts are silent on the impact of those assumptions proving to be invalid. This is shaky ground. For example, if call volumes at a help desk exceed the assumed threshold, does the supplier stop answering calls? Does the customer cover the cost of employing new personnel? Is there a proportionate increase in charges? What if the increase in call volumes was due to a failure by the supplier?

To avoid running aground on the assumptions, it's worthwhile focusing on when they do and do not apply, the impact on pricing and levels of service, and the steps to be taken to minimise the impact of invalid assumptions.

Ultimately, the nature and objectives of a project should dictate whether fixed price is the appropriate pricing model. If it is, working through some of the "what ifs" set out above can help reduce the risks of a fixed-price contract and shore up the foundations for a successful project. ■

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