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PAYMENT MECHANISMS AND RISK ALLOCATION

Outsourcing Guidance Note

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The link between payment mechanisms and risk allocation

The contractual position on risk allocation is set out in the contract. Where a risk is one that is transferred to the supplier, the price paid by the Contracting Authority reflects this and there is no adjustment mechanism if the risk occurs and impacts the supplier's cost base (because it has already priced in the risk).

Where a risk is not transferred (or not wholly transferred) to a supplier, contractual mechanisms exist to adjust the price paid to the supplier by the Contracting Authority. The payment mechanism is used to reflect the risk position. The payment mechanism and the approach to risk transfer need to go hand-in-hand.

Where the Contracting Authority wishes to exercise a significant degree of control over **how** the services are delivered, it should be responsible for managing all or most of the risks and in such circumstances adopt an input based pricing model. This normally involves adopting a *Cost Plus* or a *Time and Materials* pricing mechanism. The pricing and supplier margins should reflect the input costs only - i.e. there is no risk premium. For Contracting Authorities, the biggest disadvantages are lack of price certainty, and the resource requirement needed to be able to gain sufficient assurance on supplier costs. Input based pricing models will also limit the extent to which the supplier can innovate or differentiate service delivery.

Where the Contracting Authority considers that the supply market is best placed to determine **how** the services are delivered, it should specify only the outputs it requires - i.e. **what** to deliver. It is the supplier's responsibility to find the optimum way to deliver those outputs. In this scenario, the risks associated with delivering the supplier's solution sits with the supplier. Buyers can also expect the margins to be higher for contracts where suppliers take on the risk of delivery. In theory this is more than offset by greater expertise in delivery and greater innovation.

In developing their bids, bidders will evaluate the risks they are taking in a particular deal or transaction and incorporate within their price a value for taking those risks. The formal cost line, within a supplier's cost model is normally called a "risk pot."¹

If a Contracting Authority is specifying an output based pricing model and transferring delivery risk to the supplier, it should refrain from also specifying inputs - i.e. how the supplier should deliver this model. There are many examples of government requiring output based solutions and services and then specifying the inputs. This can potentially result in confusion about who is responsible for delivering the output and result in poor performance.

¹ It should be noted that suppliers can also price for risk in their operating assumptions. Taking a prudent approach here prices in for various operational risks and is "less obvious" if scrutinised by a buying organisation than pricing for the risk in a risk pot.

Broadly, there are six common approaches to structuring payment mechanisms.

To determine the most appropriate payment mechanism structure, it is essential to understand what the mechanism is pricing in two dimensions:

- Whether the pricing applies to inputs or outputs (outcomes being a development on outputs).
- Whether the pricing applies to the supply of projects or services: each with associated performance controls, e.g:
 - Projects: apply Delay payments
 - Services: apply Service Credits.

For example, the Fixed Price payment mechanism transfers risk in alternative directions when applied to projects vs. services.

Projects: Fixed Price per Milestone - risk transfers to supplier to deliver a milestone, subject to any delay payments.

Services: Fixed Price per Time Period - risk transfers to Contracting Authority; e.g. a monthly payment is contracted, subject to any Service Credits.

The six most common payment mechanisms are in the table below. Further detail on each of the six payment mechanisms can be found in the following table.

Payment Mechanisms for Inputs and Outputs/Outcomes, for Projects and Services

Units as→ ↓ Supply	Inputs	Outputs/Outcomes	Hybrid: incentivised Input & capped Output
Projects:	<ul style="list-style-type: none"> ❶ Time & Materials ❷ Cost Plus 	<ul style="list-style-type: none"> ❹ Fixed Price per Milestone 	<ul style="list-style-type: none"> ❸ Guaranteed Max. Price Target Cost (GMPTC)
Services:	as above or <ul style="list-style-type: none"> ❸ Fixed Price per Time Period 	<ul style="list-style-type: none"> ❺ Volume Based (including Payment by Results) 	

Additional information: Payment mechanisms

This paper considers six common payment mechanisms. The table below sets out, at a very high level, some initial considerations to bear in mind when constructing each payment mechanism in relation to risk transfer.

Variations exist within some of these approaches, e.g. Cost Plus on how the “plus” is derived: whether as a %, or flat rate, and these are included below.

Multiple payment mechanisms can be applied to a project/service. E.g. where a service has a large fixed cost element but also a separate variable cost element, the payment mechanism might comprise of:

- Fixed Price (per Time Period) for the fixed cost element, but
- Volume Based for the suppliers’ variable cost element.

Mechanism	Definition	Benefit: optimal risk transfer	Risk Considerations
① Time & Materials	T&M is based on a pre-agreed day rate card that is the tendered day rate price including profit.	Typically used where the uncertainty in output definition means the Contracting Authority should retain that risk on the staff time required to deliver. Its benefits are similar to those below for Cost Plus.	The pre-agreed day rate will include amounts to cover the suppliers’ staff and other overheads. If this is not discounted to reflect volumes purchased, suppliers over recover for this risk. The Contracting Authority must manage the volume and mix of days required: project management disciplines must ensure control of this.
② Cost Plus	A cost plus mechanism is one where the payments to the supplier are calculated based on the cost of	Cost Plus is typically used where the uncertainty in output definition means the Contracting Authority should retain	Cost Plus requires transparency over the supplier’s actual, direct costs and allocation of overheads

	<p>delivering the services, plus an extra amount to allow for profit (the profit paid will be the percentage tendered).</p> <p>Cost are calculated by reference to directly incurred supplier costs (often subject to tests as to allowable and disallowable costs).</p> <p>The plus element may be calculated in a number of ways e.g.</p> <ul style="list-style-type: none"> • as a percentage of costs (note this disincentivises effective cost controls as higher costs result in higher overall profit); • on a fixed fee basis (often used where management costs are relatively independent of delivery costs); • on an award fee basis (here profit is paid against meeting specified performance targets or outcomes.); • on an incentive fee basis (this is the GMPTC mechanism below.) 	<p>that risk. e.g. it is appropriate for first generation outsourcing or projects because the uncertainty as to outputs on these contracts may be too great for bidders to accurately price. Where this is the case, Cost Plus can be cheaper than other approaches, as bidders do not have to include 'worst case' risk premiums. Cost Plus reduces the risk of supplier cost pressures adversely affecting service delivery. Risk on performance can be transferred to the supplier via addition of a success fee for achieving performance targets/ outcomes.</p>	<p>plus an agreed margin. The financial management burden for Cost Plus contracts will typically be significant so as to ensure that only allowable costs are recovered and that cost levels claimed are appropriate. Supplier cost controls will need to be understood and closely monitored. This may create additional overhead costs for the supplier. Reduced overall cost certainty may make budgeting harder for the Authority. On most Cost Plus variants (i.e. other than where an incentive fee mechanism is used, as in the GMPTC mechanism below), suppliers are not incentivised to reduce costs or to improve delivery efficiency.</p>
<p>③ Fixed Price per Time Period (for Services)</p>	<p>This should only be used when the service cannot be unitised for volume based incentivisation, e.g. the management overhead of a service. Because the payment is on time period regardless of volumes, it requires the Contracting Authority to</p>	<p>Fixed price represents a transfer of payment risk to the Contracting Authority, as a pre-agreed monthly payment is paid (subject to any Service Credits). If the Service Credits are well constructed, quality risk can be managed and the supplier should</p>	<p>Known pricing allows for long-term budgeting, however risk on indexation should not be passed to the supplier where the contract is for a long period of time (e.g. via a Firm Price). It can be difficult to realise future</p>

	<p>manage quality more closely. A fixed price for a service period is paid subject to elements such as (if relevant) indexation. The fixed price is the tendered price. Service Credits act as performance controls and apply to performance failures.</p> <p><u>Variant (Authority-set Fixed Price model)</u> In the standard Fixed Price for Time Period model, the Fixed Price will be determined through competition with the winning bidder's price being the Fixed Price for the contract. A variant is possible, where the Authority itself sets the Fixed Price and bidders instead bid the service levels and quality they can provide for that price (potentially subject to minimum quality threshold requirements).</p> <p>Service Credits again act as performance controls and apply to performance failures.</p> <p>Note that this variant is not widely used. The standard model is significantly more common.</p>	<p>not be under undue cost pressures. This means that the service requirement must be well understood and well-articulated. Fixed price is commonly used for availability-based services (it is also common in contracts for construction projects – see below). <u>Variant (Authority-set Fixed Price model)</u> Where the Authority is confident in its internal should cost modeling and that it has a strong understanding of how the costs of service delivery relate to quality and outcomes. Where the Authority has a budget but neither the Authority nor bidders can accurately price the cost of the service (this would most likely arise in a first generation outsourcing with limited historic cost data). Creates strong cost certainty for all parties. May encourage VCSE participation, as bidders will not require sophisticated finance teams (as pricing is set) and as the model is closer to the grant-funded approach often used in the VCSE sector.</p>	<p>efficiency savings and take advantage of subsequent technology enhancements. If the service scope is poorly defined bidders may include a high level of risk contingency, in which case Fixed Price may not be VfM. Underbidding may lead to a supplier being unable to fund the cost of service delivery. <u>Variant (Authority-set Fixed Price model)</u> Model relies very heavily on the accuracy of the Authority's should cost modeling, and passes pricing risk to the Authority. May help drive a supplier focus on quality over price, as price is already set. Alternatively, may encourage a claims-culture where unexpected costs arise, as suppliers may pursue the Authority for additional money rather than seek to mitigate the impact.</p>
<p>④ Fixed Price per Milestone (for Projects)</p>	<p>The fixed price is broken down into a number of separate smaller fixed price elements, each payable against</p>	<p>Fixed price represents a substantial transfer of risk to the supplier. If done appropriately this can drive</p>	<p>Fixed price allows for budgeting certainty. Indexation will generally not apply as projects are usually</p>

	<p>achievement of defined milestones within the overall fixed price cap. The fixed price is the tendered fixed price. Delay payments incentivise delivery on time, with deductions for late delivery.</p>	<p>considerable value for money benefits.</p>	<p>delivered within a relatively short period of time. Fixed price encourages supplier efficiency, since they are not paid more if costs increase (subject (if agreed) to limited very specific exceptions).</p>
<p>⑤ Volume Based</p>	<p>A volume-based contract is one where the amount paid to the supplier varies according to how much the service is used. Typically it will be on a price per unit basis, but can be combined with a fixed element to cover certain fixed costs. (If the supplier is recovering fixed costs through unit prices, then higher than expected volumes can lead to “super profits”.)</p>	<p>When demand for the service is volatile or outside the supplier’s control, but unit costs are predictable by the Supplier within normal business levels. Volumes can be generated by either a call off request by the Contracting Authority or output demanded basis. The latter requires other demand management control by the Contracting Authority. Where volumes are particularly uncertain, suppliers may sometimes request a minimum volume guarantee from the Authority – it is for the Contracting Authority to consider whether this is appropriate in the circumstances.</p>	<p>Incentivises the supplier to seek to increase usage of the service, although the unit definition can mitigate this if this is not a desired outcome for the Contracting Authority (e.g. only pay for laptops if used on the network). Bidder ability to price volume/unit priced contracts is often heavily dependent on the accuracy of historic data provided by the Authority (or previous supplier). Large reductions in volume from predicted levels can lead to contract instability, re-negotiation or a failure. Volume guarantees can encourage the supplier to price in customisation that will make exit and transfer of services more difficult. Operation of the model requires a clear and agreed approach to measuring actual volumes. Does not provide cost certainty for the Authority (or profit certainty for the supplier).</p>

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<p>⑤ Payment by Results (or Outcome-Based contracting)</p>	<p>This is a common variant on the volume based payment mechanism. Here, rather than the amount paid to the supplier varying by usage, the amount paid varies instead by outcomes achieved. A payment per outcome transfers <i>revenue</i> risk to the supplier: much more risk than “Cost Plus with an award fee”, where only <i>profit</i> is at risk on outcomes.</p>	<p>When the Supplier can best bear the increased risks that arise in delivering an outcome rather than an intermediate output e.g. <i>resolution of calls</i> to a help desk rather than just the volume of calls made.</p> <p>Where the actions and processes required to reach the specified outcomes are clear, well understood, and are within the supplier’s ability to deliver.</p> <p>Encourages supplier innovation to achieve the specified outcomes.</p> <p>Focuses supplier delivery on outcomes rather than processes.</p>	<p>Outcome scope will not be appropriate where largely outside the supplier’s control. Suppliers may: be paid more for outcomes which they were not actually responsible for achieving, or fail to recover costs despite poor outcomes not being their fault. Suppliers may be incentivised to prioritise easier outcomes over more difficult ones.</p> <p>There may be an increased risk of disputes if outcomes are not clearly defined and measurable.</p> <p>Where outcomes are delayed, the supplier will be exposed to cash flow issues: this increases where volume variable costs are high.</p> <p>Ultimately, if outcomes are poor and cannot credibly be improved, the supplier may be forced to abandon a loss-making contract.</p>
<p>⑥ Guaranteed Maximum Price with Target Cost (GMPTC)</p>	<p>Bidders bid a target cost for delivery of milestones or services and a margin. The target cost and margin are together referred to as the target price. A guaranteed maximum price is set which is a specified percentage above the target price or target cost (10% above target price in the</p>	<p>GMPTC is a variant of Cost Plus and is used in similar circumstances of output uncertainty. However it transfers some risk to the Supplier as an incentive should their actual costs be lower than their target cost.</p> <p>The primary advantage of GMPTC</p>	<p>See comments against Cost Plus above, subject to the differences outlined below.</p> <p>GMPTC may better align Authority and supplier interests with respect to cost management.</p>

<p>a.k.a. TCIF (Target Cost Incentive Fee)</p>	<p>standard model contract).</p> <p>Where the supplier's actual costs are less than its target cost, the savings made are shared with the Contracting Authority and result in an increase in the margin received by the supplier.</p> <p>Where actual costs are greater than the target cost, the difference between the actual costs and the target costs is shared equally, provided that the most the Contracting Authority will pay is the guaranteed maximum price. This has the effect of reducing the margin paid to the supplier.</p>	<p>over a standard Cost Plus approach is that it incentivises cost efficiency, as the supplier's margin will increase as costs are reduced (sometimes subject to minimum performance requirements or anti-embarrassment maximum profit clauses).</p>	<p>The primary disadvantage is an even greater financial management burden than under standard Cost Plus.</p> <p>Also, the increased complexity of GMPTC may create a greater risk of inadvertent incentives (for example, if the increased margin from cost savings outweighs any deductions made for performance failures).</p>
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