F1F9 eBooks

WHY FIXED PRICE MODELLING CONTRACTS **ARE BAD FOR EVERYONE**

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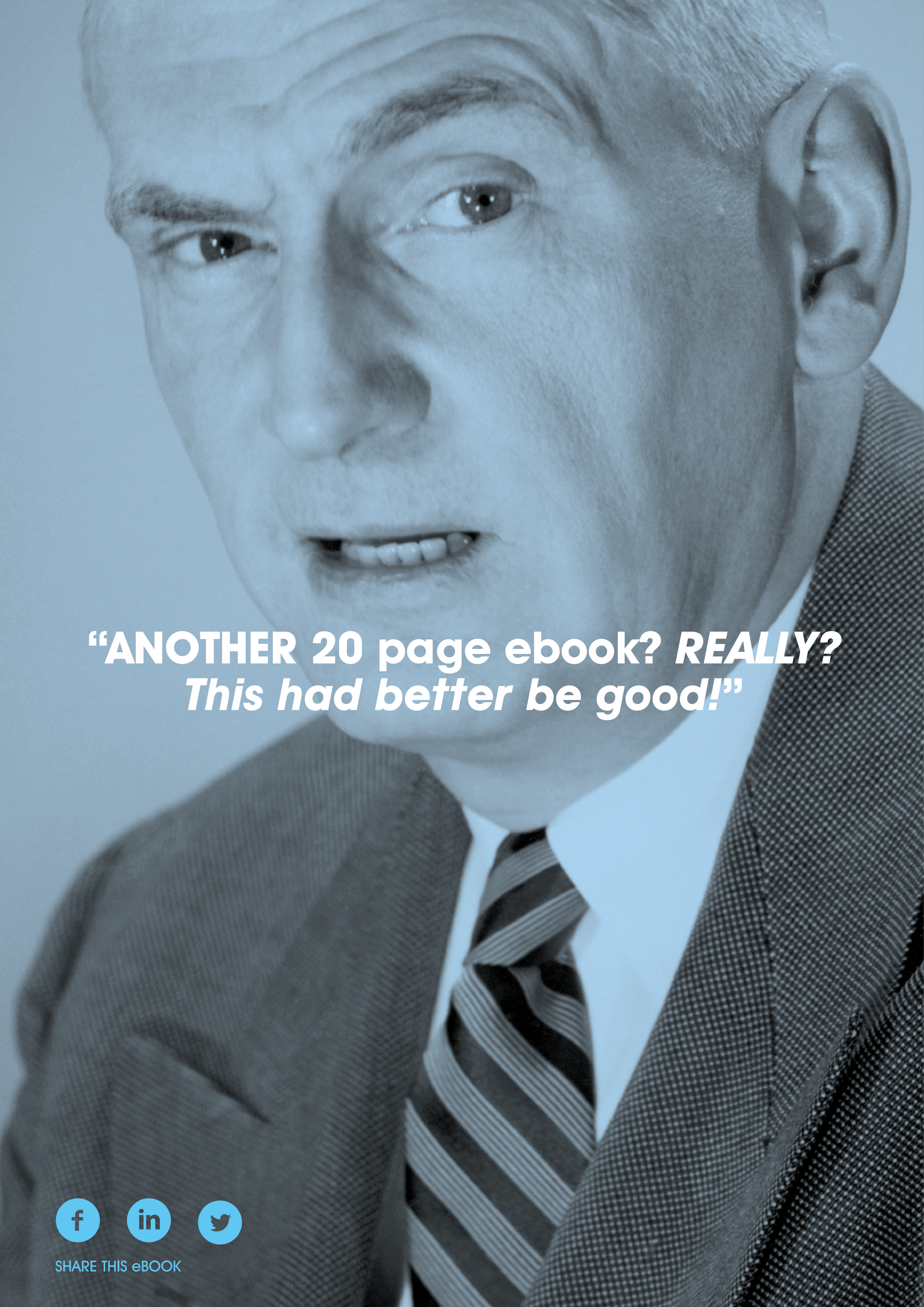

"ANOTHER 20 page ebook? *REALLY?*
This had better be good!"
SHARE THIS eBOOK

IF YOU'VE EVER HAD A CLIENT SAY TO YOU...

"WE HAVE ALL OF THESE NEEDS AND WANTS THAT HAVE YET TO BE DEFINED IN DETAIL BUT PLEASE TELL ME PRECISELY HOW LONG IT WILL TAKE AND HOW MUCH IT WILL COST?"

THEN THIS EBOOK IS FOR YOU.

INTRODUCTION

When we published our ***Introduction to Agile Financial Modelling ebook*** we noticed a common thread in the feedback we received from Financial Modelling professionals:

"We agree with what you're saying about Agile modelling, but our clients want fixed price contracts for model build. How does an iterative, Agile approach work when it comes to pricing?"

This ebook is a response to that question.

If you've ever had a client say to you, "We have all of these needs and wants that have yet to be defined in detail but please tell me precisely how long it will take and how much it will cost?" then this ebook is for you.

In the sections that follow we'll look at:

Why clients start out wanting fixed price contracts

Why fixed price contacts are generally bad news for modelling projects

How to price Agile model build assignments

PRICING FINANCIAL MODEL BUILD ASSIGNMENTS
AN OVERVIEW

It's common for clients to request fixed price contracts for model build assignments.
There are usually very good reasons for this. Clients believe that fixed price contracts reduce their risk, help them to choose between several suppliers and force contractors to prepare a viable plan. Very often the requirements of governance and due process mean that clients are forced to request fixed price contracts, even where they might prefer to take a more flexible approach.

Although there are many good reasons for clients to request fixed price arrangements, they are bad news for clients and for suppliers.

When faced with a request for a fixed price, in situations of high complexity and low certainty, consultants will often adopt one or more of the following risk management approaches:

1. Place limitations on the scope of the work in order to limit their exposure.
2. Include a large contingency for the unknown unknowns. Suppliers will often work out their best guess of the time required to deliver that scope, and then (at least) double it.
3. Underprice the fixed price element against a limited scope, believing that they will "make their money" when the scope changes, as they know it will.

These pricing strategies can result in a confrontational, rather than collaborative relationship. Additionally suppliers will sometimes be forced to compromise quality to deliver on budget.

Fixed price contracts can therefore sometimes makes a successful outcome less, not more, likely.

Moving towards a more effective, collaborative client relationship requires trust on both sides.

In order to build trust clients must be able to control the development process.

At F1F9 we have found it useful to:

1. Give clients a unilateral, no quibble, guarantee that they will only pay what they think work is worth. We send clients a regular monthly invoice for time spent, backed up with time reports. If clients feel that the bill is excessive, they pay less.
2. Recognise upfront and openly that the project is intrinsically uncertain and complex.
3. Use an Agile, iterative approach to manage the build process. (**Click here** to download our previous ebook outlining the 10 principles of Agile Financial Modelling). This simplifies the process and reduces risk for all parties by dividing the build into small, relatively low-cost steps that deliver tangible results quickly and flexibly. Clients have continuous access to the progress of the model build to check that it meets their requirements, and to request alterations as these requirements change (which they frequently do).

While offering a "client veto" has the potential to leave us exposed, in reality we have found that:

1. Clients reciprocate the trust that we show in them.
2. The client veto is hardly ever used.
3. The veto builds trust, and is more likely to lead to a collaborative, rather than a confrontational working relationship.

WHY CLIENTS WANT FIXED PRICE CONTRACTS

SOMETIMES IN LIFE THINGS DON'T WORK OUT THE WAY WE EXPECT THEM TO!

(Sorry if that came as a shock, but you had to find out sometime)

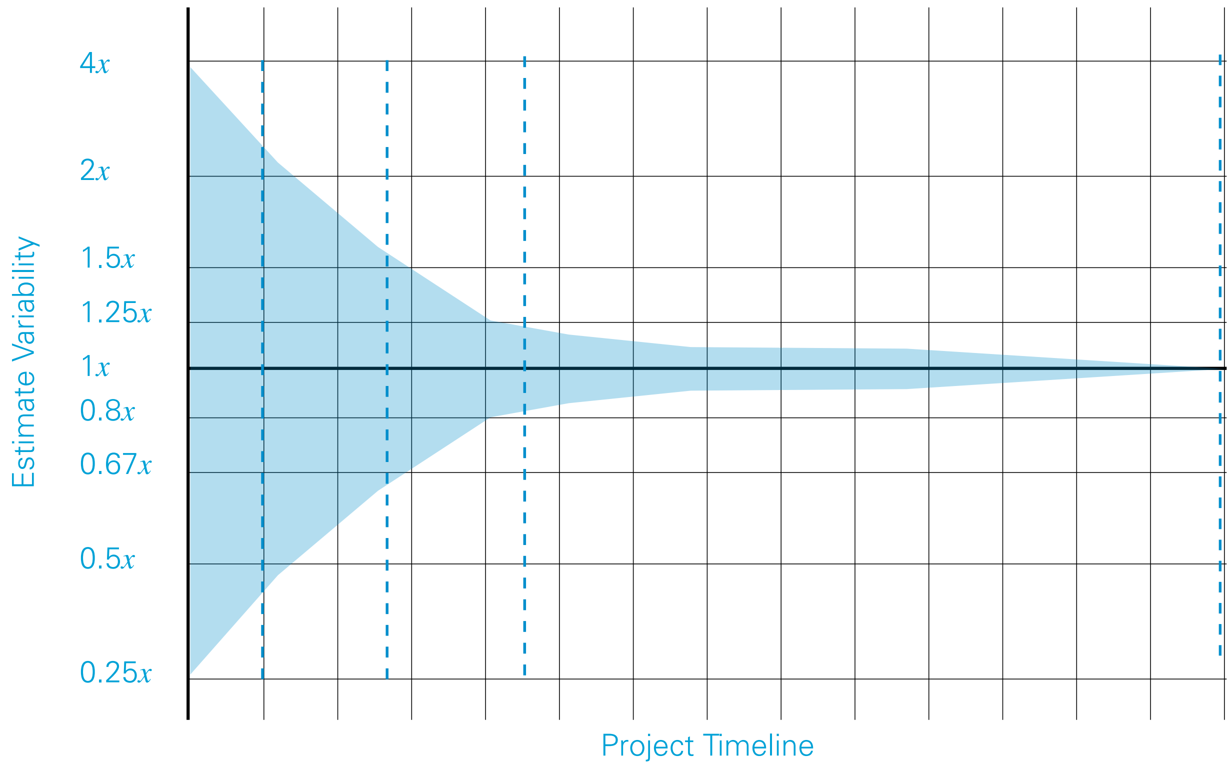
And because things don't always work out the way we expect, at the beginning of a client's relationship with you, there is a confidence gap. Not unreasonably, clients want to know what they're going to get, when they're going to get it and how much it's going to cost.

Fixed price contracts are one way that clients attempt to close the *confidence gap.* Clients perceive other benefits in fixed price contracts, which further increases their appeal:

To reduce financial risk.	Clients believe that by getting you to agree to a fixed price, they are passing the financial risk of the project onto you.
To choose between several suppliers.	The client wants the best deal possible so they put out a request for proposal (RFP) to several suppliers. These suppliers then bid for the work. This gives the client options to choose from and motivates the suppliers to reduce their margins in the face of competition.
To force you to prepare a viable plan.	By forcing you to give a (supposedly accurate) estimate that you'll be bound by, you are effectively motivated to think through how you're going to perform the work.
They are bound by procurement processes & governance structures.	For example, public sector procurement processes require a detailed request for proposal (RFP) and fixed-price tender approach. Neither you nor your client may actually want to work this way, but it is incredibly difficult for them to forgo a fixed-price approach. Very often clients would like to work in a more flexible, Agile manner, but are restricted in their ability to do so by the requirements of governance and due process.
It's just the way things are done.	For several decades people have been writing financial modelling guidance based on the "waterfall" approach to project management. (This approach usually doesn't work. See our *10 Principles of Agile Financial Modelling ebook* for an explanation why.) As a profession we have taught our clients that this is the way things are done.

The problem is that fixed price contracts often lead people to adopt approaches and behaviours that *further undermine* confidence, and make a successful outcome *less likely*, not more.

INTRODUCING THE CONE OF UNCERTAINTY



Very often at the early stages of projects, details of specific requirements are unclear. This lack of clarity leads to uncertainty around the project plan, staffing requirements, delivery milestones, etc. This in turn leads to variability in project estimates. But as these sources of variability are further investigated and pinned down, the variability in the project diminishes, and so too the variability in the project estimates can also diminish. The phenomenon is widely known to project managers, especially in software development.

Estimates created very early in a project are subject to a high degree of error.

The reason the estimate contains variability is that the project itself contains variability. The only way to reduce the variability in the estimate is to reduce the variability in the project itself. The Cone narrows only as you make decisions that eliminate variability.

The problem for suppliers and clients entering a new relationship on a new project, is that the widest end of the *Cone of Uncertainty* coincides with the lowest levels of confidence between the parties.

This results in clients requesting fixed price, time certain contracts, at the precise moment when these commitments are hardest to give...


To fill the cone of uncertainty we need
the *ice-cream of trust*, and then we can top it all off
with the *chocolate sprinkles of collaboration!*

WHY FIXED PRICE CONTRACTS ARE BAD FOR EVERYONE

"This approach reduces clients' motivation to change their defined requirements, effectively turning the change management strategy into a change prevention strategy."

FIXED PRICE CONTRACTS ARE BAD FOR CLIENTS

Clients want fixed price contracts, at exactly the stage in the process when these commitments are hardest to give.

In order to protect themselves from the (very real) risks of fixed price model build projects, suppliers tend to adopt one of the following approaches.

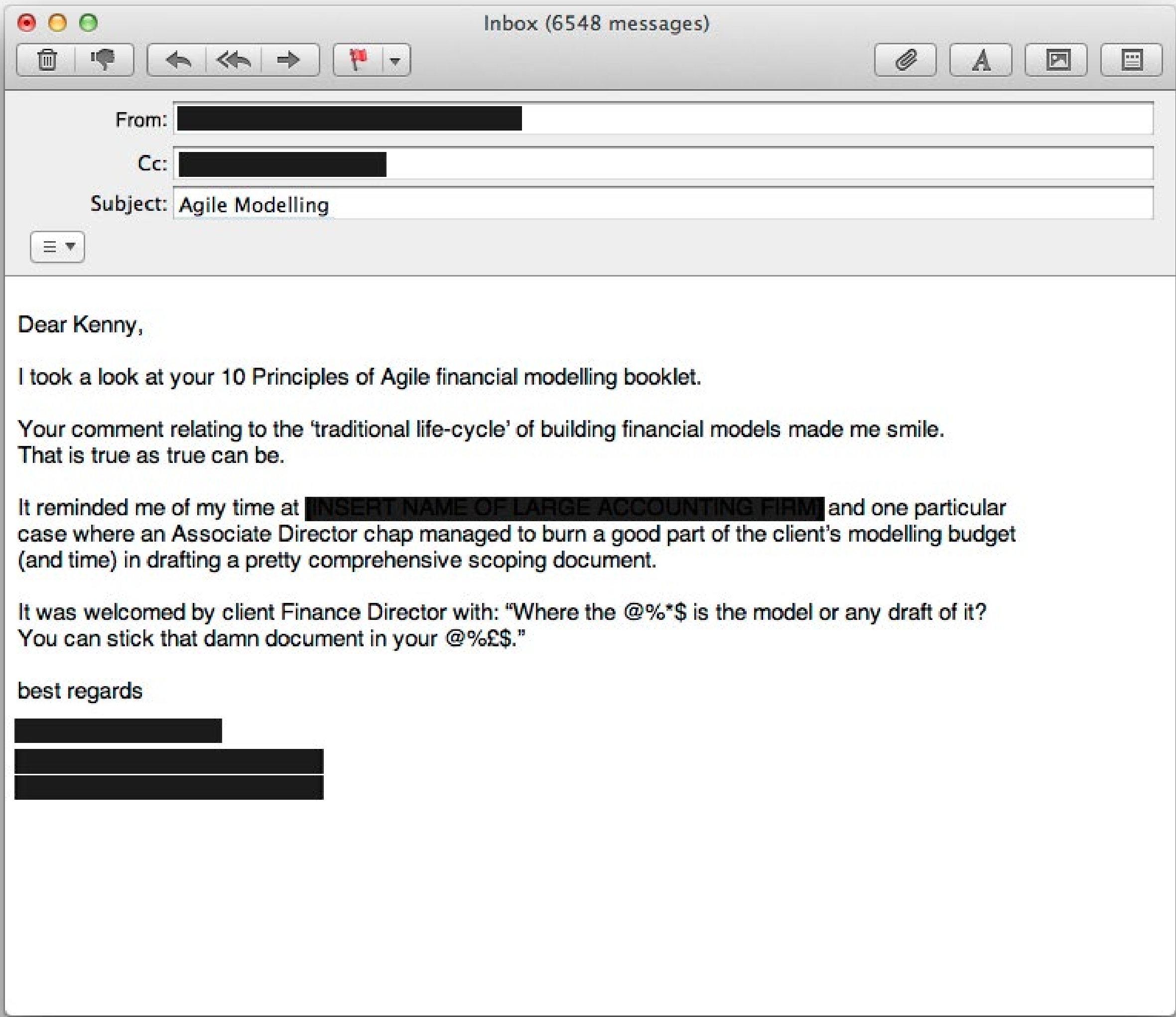
Place limitations on the scope of the work in order to limit exposure.	This has the advantage of matching the fixed price requested by the client with a fixed scope that the supplier can deliver. The problem with this approach is that it hasn't done anything to remove the uncertainty around the requirement and so it's possible that the client will get what the supplier can deliver, rather than what they actually need.
Include an enormous "contingency" in their quote, to cover the unknown unknowns.	Very often the approach taken is to work out a detailed estimate of the time the supplier thinks they will need from their experience of similar projects, and then (at least) double it. For clients the problem with this is that they are very often paying for work that doesn't actually get done.
Bid a lower price alongside a strict change management approach.	This approach makes it difficult / expensive for the client to modify their requirements. These processes are usually onerous and often make the client pay handsomely for any changes. This is especially true where the supplier has adopted the ethically questionable approach of underpricing their initial bid to win the work, in the knowledge that they will make their money through the inevitable change requests that they know will occur. This approach reduces clients' motivation to change their defined requirements, even though their requirements have in fact changed, effectively turning the change management strategy into a change prevention strategy.

In both cases fixing the scope closes off all prospect of innovation which is bad for clients. As the project progresses, discovered insights are simply excluded, or are buried alive in a negotiation / change control process.

FIXED PRICE CONTRACTS ARE BAD FOR SUPPLIERS

Working out the price of fixed price contracts wastes time. The requirement to submit a fixed price to which you are going to be held requires a lot of time to be spent on trying to estimate in detail the time input required. The time spent on working out pricing could be better spent getting on with the project. Clients often don't realise the amount of effort required to obtain just a bit more precision in our estimates.

Fixed price requirements force suppliers to engage in behaviours that they most likely don't want to engage in. It prevents them from doing their best work by ensuring that the relationship remains combative throughout the process.



Inbox (6548 messages)

From: [redacted]

Cc: [redacted]

Subject: Agile Modelling

Dear Kenny,

I took a look at your 10 Principles of Agile financial modelling booklet.

Your comment relating to the 'traditional life-cycle' of building financial models made me smile. That is true as true can be.

It reminded me of my time at [redacted] and one particular case where an Associate Director chap managed to burn a good part of the client's modelling budget (and time) in drafting a pretty comprehensive scoping document.

It was welcomed by client Finance Director with: "Where the @%*$ is the model or any draft of it? You can stick that damn document in your @%£$."

best regards

[redacted]

HOW WE CLOSE THE CONFIDENCE GAP AT F1F9

When we engage with new clients, they usually start by wanting us to work on a fixed price basis, for all the reasons we've discussed.

We have found that an effective way of giving clients the confidence and protection they need to move away from this initial position is to offer them a unilateral, no quibble veto over the hours we charge at any stage of a project.

We have found that closing the confidence gap starts with us "making the first move" by trusting our clients. Our clients decide what they think is reasonable, and pay only that.

Here's how to make this work:

Work on an open book basis, reporting time regularly to clients and giving them control over what they think is reasonable.	The Agile financial modelling approach means working in short sprints, reporting work completed, and more importantly work not completed on a regular (often weekly) basis. The client is then able to decide on what the priorities are for the next sprint. This stops you from going down blind alleys, and gives the client confidence that you're not burning their budget. Over time clients realise that they are in control, and that you're serious about building a collaborative relationship. This will help you to build a reputation for openness and honesty.
Include client training to help to set expectations.	When organisations are used to throwing a Request for Proposals document over the wall and expecting to magically get a result some time down the track, using an Agile approach is going to be foreign and potentially unnerving for them. Working in a collaborative, Agile manner will be new for most clients. It's important therefore to explain why things are different and how it's an improvement on the past. This is an important part of building trust and managing expectations. You want as much buy in and visibility with senior management as possible, you want the end users (who usually have no voice) to speak. You are preparing the customer for a new way of working.
Invest time in reducing uncertainty.	Time spent understanding the Conceptual Model can serve to a. reduce uncertainty about the requirement and b. develop a shared understanding of the complex areas of the model build before time is spent on the model engineering. The Agile approach means that a "large fixed price assignment" can be broken up into lots of small fixed price assignments, with each small step being undertaken on the basis of an agreed price and scope, and each step helping to reduce the uncertainty in the rest of the build process.

Achieve early wins to build confidence.

Rather than place unrealistic limits on the scope, break the scope into achievable "sprints." In any model build assignment not all of the requirement is uncertain. It's usually possible to make progress in time limited sprints that demonstrate delivery capability and which build trust.

Run the first iteration, trying to target at least some of the high risk / problematic areas first.

This helps to show the customer how Agile delivery works in practice. At the end of the first sprint share the hours used and have the discussion around what is reasonable. At this stage you can remind the customer about their veto if they think any of the hours are unreasonable.

Once you have a client who understands that this is better than working "the old way", and that they have complete control over priorities and spend, they are more likely to engage constructively and collaboratively to get the best solution completed within their budget.

This is better for everybody.

Reassure clients that their initial exposure is limited.

The cost of a single iteration does not represent a large financial commitment on behalf of the client. If the customer doesn't like the output, you, or the approach, you shake hands and walk away. If they do, you'll be much more likely to have a successful project and you'll probably have a customer who starts talking you up in the marketplace.

Even if the end goal is clear, the steps needed to get there hardly ever are. It's certain that something will change and that some tasks in the assignment will be a lot quicker than expected while others will take a lot, lot longer.

Huge confidence is created by clients knowing that if we do something really dumb, or try something that doesn't work, they can choose not to pay for it. When working this way, it's easier for our team to be honest about problems, delays and screw ups.

We have found that, without exception, clients exercise their veto very selectively. So far we have always agreed with their position.

Of course there is always the risk that clients will "take advantage" and withhold payment unreasonably. So far this has never happened and if it did, it would inform our view about wanting to continue working with that client.

In reality, what we have found is that

1. Clients reciprocate the trust that we show in them.

2. The client veto is hardly ever used.

3. The veto builds trust, and is more likely to lead to a collaborative, rather than a confrontational working relationship.

The client veto makes it easier for us to deal with the inevitable "bumps on the road" and move the project and the relationship forward.

Of course clients will still request an estimate of the time that a piece of work is going to take and we are always happy to provide that. The estimate is based on shared understanding of the project uncertainties that lie ahead, and will continue to be refined as decisions are taken that reduce that uncertainty.

Although no guarantee of a successful project, we have found that the following 3 elements of our approach have delivered consistently good results:

The FAST Standard	**Using a highly standardised approach to modelling gives us 3 benefits:** 1. All our modellers are working the same way and so we can easily add modellers to a project team to speed up delivery, and modellers and clients can share the model between them more easily. 2. Building models in a consistent manner allows our modellers to be highly efficient. 3. Modelling becomes much more *teachable skill* and much less *gifted art*, allowing us to more easily recruit and train modellers, and grow our team.
An Agile approach to Financial Modelling	This allows us to recognise up front the inherent uncertainties in the model build process and manage around those. Working in short iterative sprints allows the client to remain in control of the priorities, even when unexpected changes occur (which they usually do!).
Building trust through giving client a "no quibble" veto over hours	This allows all parties to have an open conversation about the real uncertainties that exist, while allowing the client to still have control over their budget. Time estimates become the starting point of a conversation, not the end of it.

F1F9 builds and maintains financial models used by leading corporates, advisors, banks and funds.

We also train our clients to build better models themselves through courses delivered worldwide.

To discuss how our team can help you deliver better models in less time, please call
Lynn Martin on +44 203 239 8575
or email **lynn.martin@f1f9.com**

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