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Pricing Models – The Management Consultant's Perspective

"A guide to practitioners for selecting the best pricing models for successful projects"

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Introduction

The idea of a study on the pricing models in the Management Consulting industry was conceived for the purpose of exploring and understanding what different pricing models exist in the consulting world. It also sought to find out if there is something more to pricing models than meets the eye. This study aims at being a practitioner's guide to what a consultant should keep in mind before selecting a particular model for a client project. It will also help them to evaluate the pros and cons of each model so that the best model for pricing the client project.

Key Findings

- Pricing can be an effective tool for consultants to use to win a project.
- Pricing becomes a more important issue when the consultants are trying to win a project where procurement is used.
- The pricing structure of a project makes a difference to how that project is conducted.
- Three widely used pricing models exist namely – Fixed Price, Time and Material (T&M) and Risk-Reward. These pricing models have been reworked in a number of ways providing practitioners with different variations and hybrids of these models.
- The Fixed Price model seems to be the most popular amongst consultants followed by T&M and finally Risk-Reward.
- Risk-Reward is frowned upon by clients due to its complexity and the level of involvement that is required by the consultant in the client's business.
- 6 major influences act on the client's and consultant's decision to use a pricing model, namely – Scope of Work, Client Involvement, Client-Consultant Relationship, Revenue & Value, Risk and Transparency.
- Researchers propose that value based pricing is the way to move forward to deliver projects that are truly valuable to the clients.

Research Methodology

The project was based upon a literature review, secondary quantitative data provided by the Management Consultancies Association (MCA), and interviews with 6 individual senior level management consultants.

Outcome

Pricing Models

Much of the research considering pricing has pointed out 3 core pricing models that are practiced in the management consulting industry: Fixed Price, Time and Material and Risk-Reward. This research revealed that each type of pricing model is suitable for a particular type of project. For instance, Fixed Price approaches would be more suited to projects where the consultants have already worked on something similar and hence becomes applicable to where toolkits may be used. A time and materials model would best suit a project where neither the consultant nor the client are completely sure of what the client needs are or how complex the project may be - which makes estimations difficult. Finally, a risk-reward project is sometimes the best solution to motivate consultants to bring about radical changes in the client business.

All projects seldom tend to be the same in all situations, which call for a number of variations to be made with the pricing models. Certain cases have seen the inclusion of a maximum limit to the amount a consultant can be paid for on a project commonly known as the capped T&M whereas others have seen the inclusion of a money back guarantee in their fixed price agreements to be exercised when the client was not happy. Further, some projects may require a Target Cost Incentive scheme which is a variant of the risk-reward in which the consultancy is rewarded only if it completes the project below a certain price.

One size doesn't fit all

Each of these pricing models come with their own disadvantages in contrast with their advantages, which places great importance for a balanced decision to be made in terms of what pricing model should be used depending on the project at hand. But it's not always just the balancing of the pros and cons that are important but other factors play a major role in deciding the appropriate pricing model. Six factors have been found to play a role in the decision making process:

- Scope of Work – If the scope of work has been defined clearly, the clients and consultants may go ahead with the fixed price or risk-reward model, whereas if it is unclear, a T&M model would work out best for both parties.

- Client Involvement –The client may want to use a T&M model if they want more control over the project or a risk-reward model where riskier decisions are to be made. A fixed price model where the client may not have the capabilities or the time to handle the project.

- Client-Consultant Relationship – If the client and consultant are starting afresh, then it is likely that the clients may push for a T&M model. A fixed price or a risk-reward model is more likely to be seen in mature relationships where a high trust has been achieved.

- Revenue and Value – Depending on the revenue being earned by the consultant and how much the client values the project, the project may go for a T&M mode. If the client does not consider the project/phase as important, a fixed price if the revenue for the consultant might be used. A risk-reward model can be used if the consultant sees an opportunity for a great reward and the client understands how valuable the project is for the company and foresee the potential benefits from taking up the project.

- Risk – If the client is ready to bear the maximum amount of risk, the T&M model should be utilised but if the risk is to be divided and responsibility is to be shared, then a risk-reward model give both the best opportunity to do so. A fixed price model would see the consultant bearing most of the risk as costs are now the responsibility of the consultant.

- Transparency – T&M provides a great amount of transparency to the clients as they ostensibly know how many hours the consultants have worked on their assignments and are paid accordingly. A fixed price model would not be transparent enough for clients to know exactly how much it cost the consultancy. Finally, the risk-reward option provides an open environment where both the clients and consultants work collaboratively where clients and consultants would share important information and project progress with each other frequently.

Final Thoughts

An appropriate use of the right model for the right kind of project makes sure that both the client and consultant feel responsible for the project and that they are an integral part of it. The clients must choose the right pricing model to motivate the consultants to do a better job and it becomes the responsibility of the consultants as well to offer better alternatives for pricing the projects.

The six factors that were described above, though point out to being important on their own, must be evaluated against each other to finally draw down to a single pricing model. If such a pricing model does not exist, consultants and clients must work together to form a model which may be a variant or a hybrid of an existing model or could be a new form of pricing altogether.

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APPENDIX 1 Advantages / Disadvantages of Pricing Models

Pricing Model		Clients	Consultants
Time and Material	Advantages	• Greater Control over the project. • Simple and transparent method of calculating the total fees of the consultants.	• Minimal risk in project. • Provides an opportunity to create trust with clients.
	Disadvantages	• Risk of budget overrun. • Responsibility to carefully manage scope creep.	• Revenue is limited to the time that the consultancy works for the client.
Fixed Price	Advantages	• Know how much the project shall cost at the start of the project. • Change management is handled by consultants. • Ability to compare with other bids.	• Efficiently managed projects tend to make profits. • Project management lies in the hands of consultants.
	Disadvantages	• Inexperienced clients may not have explored the market well, may accept expensive quotations. • Client has minimal authority over resources assigned. • Arguments on scope changes after scope lockdown.	• Risk of project budget overruns. • If objectives are not clear, projects may run astray.
Risk-Reward	Advantages	• Consultancies objectives are aligned with the business objectives. • If desired results are not achieved, clients can retain a part of the agreed reward.	• Opportunity to gain a large reward sum.
	Disadvantages	• Wrong performance metrics lead to wrong behaviour. • Tedious process to decide on the mode of reward to be paid to consultants. • Difficult to isolate results that have been achieved solely due to the success of the project.	• Risk of losing a major part of income from the project. • Disputes may arise when deciding whether consultancies should be paid their reward or not.