Making 'getting what you pay for' a reality in CRE outsourcing deals

Kate Vitasek* and Michele Flynn**

Received: 29th January, 2018

*E-mail: kvitasek@utk.edu

**E-mail: flynn@sireas.com

Kate Vitasek *is a faculty member for graduate and executive education at the University of Tennessee's Haslam College of Business Administration. Her award-winning research has been featured in six books including:* Vested Outsourcing: Five Rules That Will Transform Outsourcing *and* Vested: How P&G, McDonald's and Microsoft are Redefining Winning in Business Relationships*. Kate's most recent book* — Strategic Sourcing in the New Economy: Harnessing the Potential of Sourcing Business Models for Modern Procurement — *has been widely endorsed by some of the most progressive procurement leaders across the world.*

Michele Flynn *is a visionary and expert in the fields of outsourcing, facilities management, real estate and governance. She serves as executive chairman for SIREAS, LLC, working directly with clients to provide vision, strategy and guidance. Michele was the founder and CEO of Expense Management Solutions, where her leadership and expertise were integral to developing performance-based contracting for global outsourcing relationships in corporate real estate and administrative services. Michele's 25+ year career has made her a subject matter expert and sought-after speaker on subjects ranging from third-party risk management and governance to corporate real estate, corporate procurement and risk and compliance.*

Abstract

Perhaps no other topic creates as much apprehension between a buyer and a supplier as trying to negotiate a fair price for corporate real estate (CRE) services. The conventional procurement process puts buyers and sellers on opposite sides of the table until the parties 'get to yes'. While a buying company and service provider often 'get to yes' and establish a business agreement, they will frequently face renegotiations. Buyers especially become frustrated — often blaming suppliers for not honouring their original price. Rather than being frustrated, buyers should look in the mirror and say: 'Did I get what I paid for? And if not — why?' The primary reason is that the process for establishing pricing between buyers and suppliers has historically been broken. How so? At the heart of the misalignment is that conventional sourcing business models usually result in the buyer company and their supplier establishing a 'price' that reflects the circumstances at a point when the business agreement is established. A 'price' is not responsive to changes in the scope of work, in the market, or in corporate strategy. In addition, many companies do not take the time to use more advanced sourcing business models and pricing mechanisms designed to keep a buyer and supplier relationship in equilibrium as 'business happens'. In the October 2018 issue of the Corporate Real Estate Journal (CREJ) (Vol. 8, No. 2) we shared the fundamental tools practitioners can use for pricing a CRE deal. This paper goes a step further and provides a deep-dive

Corporate Real Estate Journal
Vol. 8 No. 3, pp. 277–291

2043–9148

into pricing and suggests the most appropriate way to establish fair pricing for each type of sourcing business model. We conclude with a call to action for practitioners to evaluate existing pricing models to ensure appropriateness for the business.

Keywords: pricing, pricing models, best value, sourcing, sourcing business models, real estate, facilities management, outsourcing, Vested Outsourcing, performance-based, outcome-based, incentives

INTRODUCTION

Why do so many companies find themselves back at the negotiation table after they have negotiated a 'deal'? We believe it is the nature of the pricing process itself that causes consternation.

There are three significant reasons for discord. First, dissatisfaction is often directly related to the pricing approach used (or more appropriately, a lack of a well thought-out and aligned approach). In their rush to 'get to yes', parties negotiate and lock-in early on a 'price' — only to find that business conditions change, unknowns become discovered and the price is now no longer 'fair'. By definition, CRE services, in particular facilities management (FM), vary substantially based on uncontrollable issues such as weather, changing business needs and corporate growth strategies. We advocate for companies to understand and know when to use a 'price' versus a 'pricing model'.

A second reason stems from companies adopting a muscular, lowest-price-possible mindset in which buyers aim to squeeze short-term price concessions from their suppliers. Procurement philosophies introduced in the 1980s, such as the Kraljic Model, encouraged businesses to assert their buying power to condition their supply chains and force a change in the demand curve to minimise dependency on suppliers. This has led to the commoditisation of services in many industries as companies seek to 'bid and transition' to pit supplier against supplier. The more companies apply these dominating 'I-win-you-lose' methods, the more suppliers hunker down to protect margins and use short-term tactics to win the business, knowing they will be back at the table with tactics to increase their price once work is transitioned.

Finally — and all too often — companies rely on a conventional transaction-based business model rather than using a more appropriate outcome-based or investment-based sourcing business model that will best meet their business needs. Research conducted by the International Association for Contract and Commercial Management (IACCM) validates that most companies operate in a conventional transaction-based model constrained by formal, legally oriented corporate policies.[1] There is growing awareness that this approach is ineffective, given the dynamic nature of today's business environment, and does not always achieve each party's intended long-term results. Rather, it creates perverse incentives and missed opportunities to drive investments and innovation.

Bottom line: companies that want to prevent these common traps should start by first understanding — and using — the right tools. In *CREJ* ('Pricing 101: Understanding the basics of pricing a corporate real estate outsourcing deal'), we shared the tools organisations can use for determining a fair price for CRE services. This paper provides deeper-dive insights and recommendations CRE professionals can use to proactively align the right pricing mechanisms to the right sourcing business model that best fits their sourcing situation.

ALIGNING THE PRICING MECHANISMS WITH THE BUSINESS MODEL

In the April 2018 issue of *CREJ* (Vol. 7, No. 3), the authors shared how to apply sourcing business model theory to sourcing and contracting for CRE services. As an organisation's need becomes more complex, riskier and/or requires higher levels of continuous improvement or innovation, sourcing business model theory suggests an organisation should shift to a performance-based or Vested model as the foundation for their outsourcing relationship.

In the October 2018 issue (Vol. 8, No. 2), we shared the fundamental tools practitioners can use for pricing a CRE deal and challenged CRE professionals to understand the pricing tools in their toolkit. One of the biggest mistakes a company can make when trying to establish fair pricing, however, is to use the wrong sourcing business model. The problem worsens when a company does not align the right pricing mechanisms (compensation method, price versus pricing model) with its chosen sourcing business model.

This paper is a deep-dive into why and how to construct the most appropriate pricing approach for each sourcing business model, starting with transaction-based. We share typical pricing mechanisms and discuss inherent incentives and pros/cons for each model.

Transaction-based models

Transaction-based business models have been the cornerstone of business endeavours for centuries and remain the most common of sourcing business models in use today. There are three transaction-based sourcing business models: basic, approved provider, and preferred provider. Each is explained in the April 2018 issue of *CREJ*. As the commitment between a buyer and supplier increases, buyers will often shift their suppliers to 'approved provider' or 'preferred provider' status.

Typical pricing mechanics used

Transaction-based models typically use *prices* instead of a *pricing model* and payment is triggered when transactions are completed. The supplier gets paid by the transaction; therefore, the more transactions, the more revenue for the supplier. The transaction price can be based on labour, product, or unit of service. Some common examples are:

- A heating, ventilation and air conditioning (HVAC) contractor supplies labour to manage PMs on a blanket purchase order (PO), supplier bills for staff on a fully loaded cost per hour;
- An interior designer provides design development documents for a flat price per usable square foot designed;
- A moving contractor provides services inclusive of vehicles, labour, boxes and supplies at a set price per person moved;
- A local broker provides transaction support for a set price per rentable square foot.

There are two common pricing approaches for transaction-based agreements: staff augmentation and price per transaction. The main difference is that staff augmentation is typically tied to labour (how many hours/days were worked), while price per transaction is tied to completing a product unit/unit of service. Table 1 summarises the typical characteristics of staff augmentation and price per transaction approaches.

While transaction-based agreements can be open or closed-book, it is very common to use a closed-book fixed price compensation method where the buyer and seller establish a unit price per transaction for a particular task, with limited visibility for the buyer into the composition of the unit price.

INHERENT INCENTIVES — PROS AND CONS

By far the biggest advantages of a transactional pricing model are simplicity and flexibility. Agree on a price and pay for what you use. The strength of transactional pricing is also the Achilles' heel, because

Table 1: Summarised characteristics of common transaction-based approaches

	Two most common transaction-based pricing approaches	
Characteristic	*Staff augmentation*	*Price per transaction*
Typical business drivers	Overhead reduction and variable staffing	Variable costs (people and infrastructure)
Work definition	Focus on *who* and *how*	Focus on *how*. Use statement of work to define work
Desired outcomes	Hours of work completed	Transactions completed at desirable quality specifications
Economics/compensation method	Price vs pricing model Hourly/daily rate per FTE. Can be *cost reimbursement* or *fixed price* with more tendency to be *fixed price with profit and OH as a markup on people cost*	Price vs pricing model. Per unit/activity (cost per call, cost per unit, cost per shipment). Can be *cost reimbursement* or *fixed price* with more tendency to be *fixed price*
Governance structure	Direct oversight/supervision where 'boss' signs off on work	Oversight through quality metrics, volume tracking, service level agreements (SLAs). Larger 'preferred' suppliers may be managed under a supplier relationship management programme
Typical mindset	Zero sum/win–lose	Zero sum/win–lose

Source: University of Tennessee

the supplier revenue is directly tied to the volume of transactions — the more transactions, the more revenue; the more revenue, the more profit. Transactional pricing creates an inherent perverse incentive for the supplier to focus on performing activities versus driving efficiencies. It makes sense when you think about it. If you are paying your supplier a price per hour or per person for a custodial worker, the supplier is most profitable when they use a lot of hours and have many people.

RECOMMENDATION

A transaction-based pricing model is effective for simple transactions with an abundant supply, low complexity and little asset specificity (unique or custom requirements). If the level of dependency and the shared value are low, transaction-based models are the way to go. They also work well when there is high variability in volume — ie when you do not need full-time ongoing services but need them occasionally.

Transaction-based pricing does not work well if there is a high degree of customisation, significant training, or the service requires tight integration with the buyer or other supplier organisations. Each variable requires investment and consistency of supply base, which means higher fixed costs unique to one particular customer.

OUTPUT AND OUTCOME-BASED MODELS

There has been a trend in CRE to shift to output and outcome-based models for more complex CRE environments. Output and outcomes-based models link a supplier's compensation to its ability to perform against prenegotiated goals or commitments.

Rolls Royce PLC was the first known organisation to formally explore outcome-based approaches in the 1960s while making engines for aircraft clients. In this approach, the buyer often increases the scope of work and reduces the level of detail in the statement of work — focusing on 'outcomes'. Rolls Royce's outcome-based model is called the 'Power-by-the-Hour'[2] programme. Under the model, Rolls Royce assumes the risk for operational uptime and gets paid a fixed fee per hour of operational uptime. This flexibility allows Rolls Royce to use its expertise efficiently and cost-effectively to deliver the desired outcome: a well-maintained engine that decreases aircraft downtime for its clients. Rolls Royce benefits by having a steady revenue stream it can use to level load resources and budget for optimised maintenance during the life of the engine. The airline benefits because regularly scheduled, expertly provided maintenance results in fewer planes that require unexpected repairs, increasing the number of hours the planes are operational.

Output and outcome-based business models have increased in popularity in the last few years. There are two broad classifications: performance-based agreements (which focus on supplier-controlled outputs) and vested agreements (which focus on boundary-spanning business outcomes). Table 2 summarises the typical characteristics of performance-based and vested business approaches.

We explore both models in more detail below with the emphasis around a deep-dive into the pricing models for each.

PERFORMANCE-BASED AGREEMENTS

A performance-based agreement (sometimes also referred to as a managed services agreement) seeks to create a formal, longer-term relationship with the intent that the supplier's compensation is linked directly to performance and/or the ability to deliver cost savings or other service improvements. Buyers typically define the level of performance required and competitively bid the work to determine which suppliers can meet the buyers' needs at the best value. Performance-based pricing agreements are sometimes called 'pay for performance', because they often have positive and/or negative incentives tied to outcomes (often called gainshare/painshare).

TYPICAL PRICING MECHANICS USED

Performance-based agreements can be structured as fixed price, fixed price per unit or cost reimbursement. One approach is referred to as a guaranteed maximum price (GMP). GMP deals have grown in popularity for FM because they enable budget predictability. As CRE outsourcing has matured, organisations have shifted to more of a hybrid approach using a mix of fixed price (management fee), transactional and cost reimbursement components in their pricing models to better align with the breadth and complexity of services within the scope.

At its core, a well-designed performance-based agreement provides behavioural incentives for the supplier to keep costs low and performance high. A hallmark design principle of a performance-based agreement is the use of incentives and at-risk fees to help align the parties' interests by creating a band of performance tied to the supplier's price. The incentives and at-risk fees help align the economics of the relationship based on the level of service received. For this reason, performance-based agreements typically require high levels of interaction between a supplier and a buyer to review performance against SLAs and assess the incentive or at-risk fees typically embedded

Table 2: Summarised characteristics of common outcome-based approaches

	Performance-based/managed services	*Vested*
Business model		
Economic model	Output-based	Outcome-based
Relationship model	Relational contract — collaborative	Relational contract — highly collaborative
Vision and intent	Performance to SLA — process efficiencies	Shared vision, desired outcomes and value creation
Scope of work		
Statement of work and objectives	'What' (narrowly defined as the supplier's responsibilities, as defined by the client)	'What' (broadly defined as the areas to be addressed, as collaboratively agreed)
Performance management		
Performance focus	Output-based SLA	Strategic desired outcomes
Performance measures	Operational + relational (values and behaviours)	Operational + transformational + relational system-wide key performance indicators (KPIs)
Pricing		
Pricing model and incentives	Price or pricing model with incentives and/or penalties	Pricing model with value-based incentives
Governance		
Relationship management	Oversight emphasis: supplier relationship management	Insight emphasis: strategic relationship management
Improve, transform, and innovate	Supplier-driven to meet SLAs/price	Joint and proactive transformation management
Exit management	Performance-based termination for cause with safeguards	Joint exit management plan
Compliance and special concerns	Corporate-based audit requirements	Outcome-based joint requirements

Source: King et al.[5]

in the contract. These reviews are periodically scheduled and include representatives from the supplier and the buyer company.

INHERENT INCENTIVES — PROS AND CONS

A powerful advantage of a performance-based agreement is the fact it ensures a supplier keeps its eye on performance and costs. Well-structured pricing models tightly align the economics of the deal to the supplier's performance and inherently incentivise the supplier to meet contractual SLAs at committed prices. GMP deals, in particular, allow buying organisations to have a predictable budget, because the supplier commits to keep costs at or below the quoted price.

A good performance-based pricing model also creates a self-executing contract with clearly defined metrics and measurement methodologies; determining the actual incentive payment simply becomes a reporting requirement. While the self-correcting nature of the agreement is a core strength, it can also be a downfall, because often there is a tendency towards over-simplification, which can create inherent perverse incentives.

One inherent perverse incentive is that the supplier optimises service/costs only for themselves and only for the duration of the contract. For example, a city utility district that operates a large water treatment plant hired a supplier to manage maintenance of the plant. If in the performance-based agreement the supplier is incentivised to achieve operational SLAs only, focusing on operational SLAs will allow the supplier to get a green scorecard every month. While this is great for them, it would be far more beneficial for both parties if the supplier carried out more proactive maintenance to maximise the performance of the plant's lifetime. Unfortunately, more preventative maintenance would increase the supplier's costs (potentially decreasing its margin). Suppliers easily justify that they will forego maintenance in the short term if there is no risk to operational performance (achieving their green scorecard). After all, why invest now when the buyer is likely to bid out the work at the end of the contract? And if the supplier made the investments and lost the bid, they truly would face a lose–lose scenario. Correctly structuring metrics to focus on the total life cycle and not just operational SLAs can mitigate this risk.

Many companies such as the city utility district above struggle with how to properly apply incentives. A great example of a bonus system gone awry is the idea that if a supplier outperforms a service level, it should automatically get a bonus. This only works if there is a corresponding business benefit. If a customer needs a supplier to complete employee moves before 5.00 a.m. on Monday morning, the value of the service will likely be degraded if the supplier is still moving people into the workweek; however, it is unlikely that getting the moves completed on Saturday instead of Sunday will provide any additional value, so an offset or bonus is not appropriate. Contrast this with a development project where beating a deadline may mean going to market earlier with a product. The key decision point should be whether incremental value is gained from incremental performance improvements against SLAs.

GMP deals have several perverse incentives built in. By definition, GMP means that the supplier cannot go back to the buyer and request more funds unless there has been a change in scope. This means the supplier must factor all potential risks into the pricing structure. As an example, because the supplier cannot predict snowfall, it will likely assess what is the 'average' snowfall for a given site and then include a contingency factor to cover its risk in case there is extraordinary snowfall. As a result, the buyer will pay for that risk. If the snowfall is average or below, the buyer will receive no rebate. Another perverse incentive is that GMP deals are by design rigid. A supplier will be far less flexible in assuming more work under a GMP because it has bid a fixed price for a fixed set of services. Each new service or activity will need to be scoped and bid separately, and the contract will need to be amended to accommodate the negotiated incremental costs.

Another potential drawback of inappropriate application of a performance-based contract is what University of Tennessee researchers call a 'watermelon scorecard'. This happens when suppliers are meeting SLAs, but the buyer perceives the supplier is still failing to meet the company's business objectives. Simply put, performance is green on the outside, red on the inside — like a watermelon. If you are experiencing a watermelon scorecard, it may be a signal that your business is better suited for a Vested business model or that you are not measuring the things important to the buying organisation. Ongoing governance and review of the performance measures throughout the life of the contract and relationship can help mitigate this risk.

Other potential drawbacks occur when clients bury the cost of governance into the supplier's transaction price or management fee without ensuring there are sufficient funds to cover this responsibility. Suppliers also suffer when their clients do not invest in proper governance. Suppliers often will bring ideas to buyers to help drive efficiencies, only to find the buyer does not have appropriate mechanisms to drive sound decision making and support the implementation of these ideas. Or worse, they make investments right for the relationship only to find that a 'new sheriff' rides into town and does not honour previous decisions, which places their investments at risk.

Finally, when suppliers are held accountable to meet guaranteed glidepath price reductions, they may feel margin pressure. When this happens, buyers can quickly see the 'A' team on their account move off and be switched with the 'C' team.

RECOMMENDATION

Performance-based approaches can succeed wildly or be hugely disappointing. Failure occurs most often when companies use a performance-based sourcing business model when another approach would fit better. A performance-based approach works best when the supplier is placed in a static 'black box' and asked to optimise productivity and costs in the 'box'. It is simply unfair to ask a service provider to sign up for putting its compensation at risk if the nature of the business itself is risky. We recommend to only use a performance-based agreement *if the level of dependency and the shared value is medium.*

Before adopting a performance-based pricing approach, ask these questions:

- Do you have a sound baseline where the supplier feels comfortable signing up for 'guaranteed' performance or cost reductions?;
- Is the scope of work very stable and predictable? If is it variable, can you ensure the supplier will not be taking on risk that is not appropriate? Under a performance-based model the supplier will 'bet' on the risk and the buyer must live with the predictable consequences. (If the risk turns out well for the supplier, they will earn high margins. If the risk is too much for the supplier to bear, the supplier will have an inherent incentive to marginalise performance or come back and ask for a price increase);
- Can a discrete scope of work be carved off into a 'black box' for the supplier to optimise? Work that requires significant input from the buyer or external sources probably is not a good fit because it imposes risk likely not appropriate;
- Are the cost components controllable? A general rule of thumb is a supplier should not be held accountable for 'guaranteeing' a price decrease if there is a substantial potential risk (eg foreign currency exchange, commodity fluctuations, service demand fluctuations);
- Are you prepared to devote proper governance levels to the relationship? This is especially true for the supplier, as governance is typically absorbed into the transaction-based price versus part of a more comprehensive pricing model.

If the answer is 'yes' to each of these, a performance-based agreement is potentially a good fit. If the answer is 'no', the parties will likely create friction in their relationship because the supplier will be signing up for risk not in its control. Here, the parties should consider either a transaction-based or a Vested approach.

VESTED AGREEMENTS

A Vested agreement — like a performance-based agreement — purposefully seeks to create a formal, longer-term relationship with the intent that the supplier's compensation be linked directly to performance;

however, the mindset and design principles are different. The Vested approach consciously shifts to view the supplier as a business partner — not simply as a supplier. Vested takes buyer–supplier alignment to a new level by structuring a true 'win–win' pricing model by establishing an economic engine that generates value for all parties at a high level. Procter & Gamble (P&G) uses the analogy of having buyers and suppliers 'tug on the same side of the rope' when referring to its Vested agreements, because a vested supplier sits on the same side of the table. The better P&G does, the better the supplier does … and the worse P&G does, the worse the supplier does.[4]

TYPICAL PRICING MECHANISMS USED

There are five characteristics of a Vested pricing model:[5]

- Foundation based on transparency, total cost of ownership (TCO)/value and appropriate risk allocation;
- Flexible framework based on the logic of Maslow's Hierarchy;
- Incentives (not penalties) drive behaviours;
- True value sharing with high incentives for innovation/transformation (ROI);
- Margin matching to ensure continual alignment.

Each characteristic is discussed below.

Foundation based on transparency, TCO/value and appropriate risk allocation

A Vested pricing model is based on three foundational principles: flexibility, transparency, and a shift to TCO/value versus price/budget.

The majority of Vested agreements use a *cost-pass-through model* where 'the costs are the costs are the costs', and there is no markup by the supplier. The supplier's profit is 'broken' from the cost and linked to their value/performance. Decoupling costs and profit eliminates the perverse incentive for a supplier to have more costs. It also prevents 'markup on markup' when using subcontractors, which is common in highly complex CRE deals.

The cost-pass-through model promotes transparency, enabling the buying organisation and supplier to take 'price' and turn it into visible cost drivers whereby they can collaborate on how best to reduce the overall total cost — not just the supplier's prices or the buying organisation's budget. While the pricing model should be transparent, the parties may decide to use mechanisms that are easy to administer and as such may have some components that are translated into fees for billing purposes. For example, the supplier's profit and overhead could be charged as a monthly 'fixed management fee'.

The underlying nature of the pricing model also shifts from a 'price' and 'budget' focus to one of TCO/value. In addition, the parties view risk from a very objective perspective. Risks are not something to shift to the other party, but are a fact of the business. The parties complete a thorough risk analysis and determine which party is the most appropriate to bear the risk. If a supplier bears the risk, it is paid a risk premium.

Once the cost drivers and risks are understood, the buyer and supplier organisations develop the most flexible and fair way to pay for the various goods and services under scope, using Maslow's Hierarchy as the logic.

Flexible framework based on the logic of Maslow's Hierarchy

Vested pricing models mirror Abraham Maslow's Hierarchy of Needs. Maslow's theory states it is vital to meet certain lower needs before higher needs can be addressed.[6]

The base of Maslow's Hierarchy is 'physiological needs and safety'. The equivalent of Maslow's base in a CRE outsourcing deal is the 'base services' consisting of the repetitive and stable costs associated with the basic service requirement (eg keep the lights on, keep the facilities clean, have processes that are compliant). For the buying organisation, basics tend to be around feeling safe in that the service provider can deliver on basic service and prove they can get the job done. For the service provider, the basics come in creating fair pricing that ensures it will not lose money — especially on uncontrollable risks. Simply put, a supplier cannot possibly help its client solve complex business problems if it is not at least covering basic costs.

A general rule is that a supplier earns a 'small' margin for base services when there is little risk and where the actual activities/work are more of a commodity. This typically translates into below-market margins if the work is competitively bid — often as low as 50 per cent of 'market' margin. For example, if the work was put to bid and the 'market' margin was 10 per cent, a Vested deal might have a 5 per cent margin for the base services.

The pricing in the base services is somewhat similar to a performance-based agreement in that the economics are tied to performance; however, the mindset and approach in the pricing model is different. Rather than have a fee-at-risk for non-performance, Vested pricing strategically guarantees a minimum profit for the supplier for the base book of work. The supplier will never lose money on the deal. This provides everyone peace of mind, knowing the work will be done effectively and efficiently, while also guaranteeing that the supplier's lights will stay on, payroll will be covered and the equipment or facilities will be properly maintained. The supplier can then earn incentives (see more under incentives).

The middle of Maslow's Hierarchy is 'esteem and love/belonging'. Here the Vested pricing model addresses the more complex aspects of a CRE deal and includes two design principles. The first is how the parties will address the way in which they will manage 'other services' that are more variable and riskier by nature, and the second is governance.

In a Vested agreement, there is a commitment to the partnership. As such, when new work is added into the supplier's scope, it should go to the partner by default, provided the partner is capable and cost-effective. Other services typically include either ongoing costs with significant variability, one-off needs or new services. In essence, other services enable the parties to have a fair and predefined way to pay for 'scope creep', which significantly reduces tension in the relationship. The general rule of thumb is the margin for other services is higher than the base, but less than market margin. The rationale is the buying organisation commits to provide 'other services' to the supplier under a no-bid situation as its strategic partner, and the supplier agrees that it will not hold the buying organisation hostage due to lock-in. Having a pre-agreed way to manage 'other services' designs in flexibility and reduces friction associated with lock-in and scope creep.

A Vested pricing model also incorporates the fact that the relationship is long-term and future-focused. As such, governance is essential, even more so than in a performance-based agreement. Vested pricing models always design how the organisations will fund and pay for governance — on both sides. The general rule of thumb is the supplier should earn above market margin for governance as it has an inherent incentive to hire the 'A' team. Governance costs should not be embedded in the 'base services' because by nature buyers want to reduce their costs. If governance costs are part of the base services, the supplier will have a perverse incentive to reduce the cost of governance and replace the 'A' team with the 'C' team.

The top of Maslow's Hierarchy is 'self-actualisation'. Most business — like people

— have desires. A desire is something a business wants but does not have. A Vested agreement is anchored on the buyer and supplier working jointly to create desired outcomes. But it is almost always imperative to make investments and innovation and/or transformation initiatives to achieve the desired outcomes. For this reason, desired outcomes reside at the top of a company's needs pyramid. And also, for this reason, the pricing model needs to highly compensate the supplier with high margins for their risk and investments. Using 10 per cent as 'market margin', a Vested pricing model would allow the supplier to earn two to three times the market margin — or up to 20–30 per cent profit margins — if the supplier successfully incorporates transformation and innovation to achieve desired outcomes. Most often, compensation for achieving transformation and innovation is paid as an incentive.

Incentives (not penalties) drive behaviour

A Vested pricing model uses incentives (not penalties). The supplier earns incentives when it performs well. Do a good job? Make more profit. In addition, in cost-pass-through deals the supplier is not motivated to drive up costs because their profit is tied to performance, not cost.

Incentives are typically linked to each of the pricing model components. For example, incentives can be linked to the base services (eg achieving SLA targets), other services (eg reducing time to market on a project), governance (eg improving a corporate objective such as increase Tier 2 supplier diversity spend) or to transformation (eg developing an innovation that achieves a desired outcome to improve the buying company's employee productivity).

True value sharing

Performance-based agreements often use a concept known as *gainsharing*. A Vested pricing model goes beyond gainsharing and expands the thinking to value sharing.

Harvard Business School's Michael Porter and Mark Kramer focused on the 'big idea' of shared value in their excellent *Harvard Business Review* article, 'The Big Idea: Creating Shared Value'.[7] While the article relates primarily to how companies can work with society to create shared value, the concept of shared value is crucial to the Vested approach. The pricing model must share any value gained from achieving the desired outcomes.

Value sharing seeks to improve the overall value for the organisation — not just reduce cost, as in gainsharing. Incentives can be a powerful motivator when designed appropriately. A good example is the environmental services contract between the US Department of Energy's (DOE) Superfund site known as the Rocky Flats Closure Project and Kaiser-Hill. The supplier — Kaiser-Hill — earned a base management fee of 3.7 per cent (market margin was 4.1 per cent) with incentives enabling it to earn up to 11.7 per cent profit margin when predefined outcomes were met (eg beating budget, raising safety levels, developing innovations that sped up closure, etc.). Kaiser-Hill developed over 200 innovations and ultimately earned incentive payments of US$560m. This may seem excessive until the full story is known: Kaiser-Hill saved US taxpayers US$30bn in costs and closed the site safely 65 years ahead of schedule — something almost all thought was impossible.[8]

Of course, it important to realise that value cannot always be expressed monetarily. For example, in one Vested agreement a desired outcome was to increase the J.D. Power ranking for customer satisfaction in bank branches. The CRE supplier could have an impact on the desired outcome but could not control it. In this case, the parties used non-monetary incentives. Non-monetary incentives include things such as automatic contract extension incentives, expanded scope of services, or even the customer's willingness to provide references.

Margin matching to ensure continual alignment

Vested agreements use margin matching to keep the economics of the deal in continual alignment. Typically, this means the pricing model itself is monitored to make sure it is fair for both the buyer and supplier organisations. This is crucial, since complex outsourcing agreements will probably evolve. When the pricing model generates a payout to the supplier below its minimum profit guardrail or above what can be deemed as a reasonable ROI on the total book of business, the margin matching trigger flags the parties to review the model and assumptions and, if needed, make necessary changes.

INHERENT INCENTIVES — PROS AND CONS

Organisations that make the shift to Vested find they have a significant increase in trust because the parties are speaking the same financial language.

One might think that moving to a Vested pricing model is a risky venture for a company and its supplier(s). Obviously, anything new and different involving investment in time, effort and resources imposes some risk. But the rewards can significantly outweigh the evaluated risk. One of the biggest advantages of using a Vested sourcing business model is the tight alignment of interests between the buyer and supplier. Alignment on transparent win–win economics creates an inherent incentive for the parties to work together to shift from 'pay for doing work' to 'pay for delivering on value'.

While a Vested model can deliver on the promise of transformation, the biggest challenge is that it is both different and hard. To succeed, it is imperative that buying organisations understand a 'bigger payoff' must be shared. This requires a mindset change for most organisations. Companies that choose a Vested sourcing business model must resist the urge, and corporate pressures, to demand the lowest possible price from suppliers. For suppliers, they must get comfortable with an open and transparent approach with financials. And the companies must make the shift to a collaborative approach for developing a pricing model, as the parties truly co-create the pricing model versus 'negotiate' prices.

Organisations must also go beyond merely saying and using the term 'partnership' to actually create a commercial pricing model that equitably allocates risks and rewards to create shared value during the agreement. If companies cannot do this, they should not enter into a Vested approach.

The biggest complaint about a Vested approach is the amount of time it takes. While it is possible to create a Vested agreement in less than three months, most take four to seven months once the provider has been selected, as the Vested methodology is often thought of as a paradigm shift.

RECOMMENDATION

A Vested pricing model works best when both parties are prepared to sit on the same side of the table conducting transparent, fact-based discussions about the business. Each party must clearly understand the goals and financial drivers of the relationship. A Vested approach is effective when:

- A company has transformation or innovation objectives it cannot achieve itself and needs to create a 'win–win' pricing model to incentivise the supplier to make investments needed to achieve the transformation/innovation objectives (known as desired outcomes);
- There is a need or desire to share risks and rewards. Vested deals are ideal when the business is complex and risky. It is also ideal when the buyer has decided CRE is

not a core competency and wants/needs a strategic business partner to make investments on its behalf;
- There is a high level of dependency (eg integration, high switching costs).

It is important to remember that a Vested pricing model will only work when a buyer and supplier agree to adopt the Vested business model in totality; a Vested pricing model is one of the five rules of the Vested approach, as profiled in *Vested Outsourcing: Five Rules That Will Transform Outsourcing*.[9]

MARKET VISION

Some will read this paper and think 'the author put forth a good theory, but standard real estate pricing doesn't lend itself well to either option'.

One challenge many cite is the dichotomy in pricing structures and margins between transaction management and operational (FM and project management) services. Standard market pricing in the US for transaction management is based on a commission earned as a percentage of the value of the deal to the landlord. While this is true today, we believe this needs to be challenged. Why? As a landlord, a commission model for transactions makes sense, as you are incentivising the real estate broker to bring you more expensive deals. As an occupant who is paying for that commission through your rent payment, however, a commission on transactions is a clear perverse incentive; you pay more for more expensive deals, when you would prefer to pay more if you achieve a lower price.

A second challenge stems from providers who perform both transaction management and FM services. Providers are inherently incentivised to focus more on the highly profitable transaction services and less on the lower margin — but critical — operational services. In addition, many providers who perform both transaction management and operational services operate with an opaque shield and choose to 'buy' the FM business at a loss or very low margins in an effort to win the highly profitable transactional work. This can lead to situations where a provider performs poorly due to insufficient funding in the FM services or minimally, struggles to perform at its peak capability. Outside of the US this dichotomy is not as significant, as transaction services are effectively paid an advisory or consulting fee which is often competitively bid and is not directly linked to the value of the deal.

Many clients have chosen to resolve these challenges by selecting different providers to manage transactions and FM or project management. While this addresses the concern about focus, we believe it builds complexity by requiring additional points of integration and handoffs that prevent streamlining of operations, analytics and costs structures. If one of the desired outcomes is to ensure uninterrupted provision of an effective workplace, minimal handoffs and boundary-spanning analytics will contribute to that success through an integrated CRE model. From the supplier's perspective an integrated approach is also better; typically, an integration of real estate transactions and operational services means more scope, more fees, and more opportunity to become strategically aligned with the client. While revenue goes up for a supplier, the ability for the supplier to optimise is significantly increased.

The third challenge is the fact that far too many companies are still emphasising simple 'cost reduction' and 'guaranteed savings' instead of value for money and total cost of ownership associated with the maintenance and running of the facilities compared to the quality of the service delivery and employee satisfaction with the workplace service delivery. This is exacerbated by suppliers who are willing to 'buy' the business and commit to guaranteed savings commitments, sometimes funded by the profits from the transaction business.

At this point, many would say the supplier and client goals diverge. But we argue they really do not. We argue that at the heart of CRE, clients and providers share a common vision: to deliver effective workplaces. The supplier wants to make a lot of money/profit. The client wants its supplier to earn enough profit while delivering an efficient and effective workplace. The supplier also wants to continue to help the client achieve the vision. We believe in well-designed longer-term partnerships that purposefully seek to align the buyer's and supplier's interests. A well-designed performance-based agreement is a good first step for those willing to drive to deeper integration and tighter alignment of pricing to service. Alternatively, a Vested model has proven very effective for organisations willing to truly shift to a transparent approach geared toward optimising value for money against mutually defined buyer–supplier desired outcomes.

Our vision for the future is one of buyers and providers working together to achieve common goals that will ultimately generate a true win–win for both parties. Do not assume current market norms around pricing or old-fashioned perspectives that clients and suppliers have different objectives preclude building an effective relationship that can achieve both of your goals.

CONCLUSION — YOU GET WHAT YOU PAY FOR

Collectively the authors have been involved in hundreds of buyer–supplier agreements. One thing is certain. The saying, 'You get what you pay for' is as true today as when it was originally coined.

There are no magic potions or easy answers for pricing. And there is definitely not a generic template or spreadsheet that provides the 'answer'. Rather you should view developing a pricing model as a process that parties go through to reach — and maintain — equilibrium. Doing so will ensure they do not find themselves returning to the negotiating table after they have reached 'yes'.

If we had a magic wand? We challenge companies to resist the urge to simply get to 'yes' on a price and challenge themselves to explore more advanced sourcing business models such as performance-based or Vested agreements. We would also ensure that more business people consciously choose to use the sourcing business model that best fits the characteristics of their business and actively seek to use pricing mechanisms that prevent perverse incentives.[10]

If you do make the shift to a performance-based or Vested model, take the time to develop a fair and flexible pricing model to ensure the economics of the commercial agreement stay in equilibrium over the life of the agreement.

Remember that no one approach fits all circumstances and that they all — when chosen correctly — can lead to sustainable and successful relationships.

The bottom line? It is time to adapt and adjust procurement and negotiation processes to address the rise of today's more dynamic and complex environments to create much-needed innovation.

We hope that our collective thoughts will help make 'you get what you pay for' a reality in your business.

References

(1) International Association of Contracting and Commercial Management (April 2010), 'Contract Negotiations Continue to Undermine Value', 9th Annual Top Ten Terms Report.

(2) Power by the Hour is a registered trademark of Rolls-Royce.

(3) Kling, J., Manrodt, K. and Vitasek, K. (2016), *Strategic Sourcing in the New Economy: Harnessing the Potential of Sourcing*

Business Models for Modern Procurement, Palgrave Macmillan, New York.

(4) Vitasek, K. and Manrodt, K. with Kling, J. (2012), *Vested: How P&G, McDonald's, and Microsoft are Redefining Winning in Business Relationships*, Palgrave Macmillan, New York.

(5) The term 'vested outsourcing' was originally coined by University of Tennessee researchers to describe the highly successful outcome-based outsourcing agreements the researchers studied as part of a large research project funded by the USAF. Their research revealed that vested agreements combined an outcome-based model with the Nobel award concepts of behavioural economics and the principles of shared value. Using these concepts, companies enter into highly collaborative arrangements designed to create value for all parties involved above and beyond the conventional buy–sell economics of transaction-based or performance-based agreements. See Vitasek, K., Ledyard, M. and Manrodt, K. (2013), *Vested Outsourcing: Five Rules That Will Transform Outsourcing*, 2nd edn, Palgrave Macmillan, New York.

(6) McLeod, S. (2018), 'Maslow's Hierarchy of Needs', in *Simply Psychology*, available at https://www.simplypsychology.org/maslow.html (accessed 29th January, 2019).

(7) Porter, M. E. and Kramer, M. R. (January–February 2011), 'The Big Idea: Creating Shared Value', *Harvard Business Review*, pp. 62–77, available at http://hbr.org/2011/01/the-big-idea-creating-shared-value/ar/1 (accessed 29th January, 2019).

(8) *Ibid.*, note 3.

(9) *Ibid.*, note 4; The Five Rules are: Rule# 1 Focus on outcomes, not transactions; Rule# 2 Focus on the what, not the how; Rule#3 Agree on clearly defined and measurable outcomes; Rule #4 Pricing model with incentives that optimise the business; Rule# 5 Governance structure should provide insight, not merely oversight.

(10) In the June 2018 issue of the *Corporate Real Estate Journal* (Vol. 8, No. 2) the authors provided a detailed comparison between performance-based and vested models. Given the in-depth review of each sourcing business model in this paper, we will not address them again here, except to say that the biggest mistake a company can make when trying to establish fair pricing is to use the wrong sourcing business model.