Pricing 101: Understanding the basics of pricing a corporate real estate outsourcing deal

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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 current authors believe one of the key reasons is because buyers and suppliers do not understand the fundamental basics of pricing. Pricing a CRE deal becomes much easier when you completely understand the tools in your pricing toolkit. This paper addresses five common questions with which organisations often struggle for pricing a CRE deal. In answering the questions, the paper defines and explains the pricing tools practitioners can use to make getting to a fair price easier. The paper also provides recommendations where appropriate. Lastly, the paper challenges buyers and suppliers to negotiate prices with a lens of transparency.

Keywords: pricing, pricing models, best value, compensation, sourcing, sourcing business models, real estate, facilities management, CRE outsourcing, Vested outsourcing, TCO, performance-based, outcome-based

INTRODUCTION

Why do so many corporate real estate (CRE) professionals find pricing a CRE deal painful? A key reason is that far too many do not understand the basic fundamentals and building blocks of pricing.

Companies that want to get on the right track on pricing their next CRE deal should start by making sure they know how to use all of the pricing tools in their toolkit. This paper provides answers to five common questions we are often asked. As we answer each question, we identify key terms in bold italics and provide a definition.

WHEN SHOULD I USE A PRICE VS PRICING MODEL?

One of the most common questions we encounter is 'when should I shift from using a *price* to a *pricing model*?'

To answer this question, one must first understand the difference between a *price* and a *pricing model*. A price is how much you pay for something. You pay US$3.25 for your Starbucks Grande two pump vanilla latte. A facility management (FM) provider may have a price of US$6.00 for every work order processed by the company's customer service representative.

A pricing model is dynamic and enables the parties to adjust the underlying pricing assumptions as 'business happens'. Fundamentally, the model includes mechanisms to determine the optimum monetary exchange between a buyer and a supplier by deriving the outputs based upon the relevant input components. A good pricing model equitably allocates risks and rewards with the purpose of realising mutual gains during the agreement.

In some cases, a pricing model simply includes actual costs, volume targets and incentives. Most pricing models are expressed in a simple spreadsheet; however, some can resemble a small, customised software package or a macro-based Excel spreadsheet. The best pricing models allow buyers to align a supplier's payment with value received — in essence, validating that a company is 'getting what it pays for'.

Common factors affecting a pricing model include:

- **The *total cost of ownership* (TCO)**: A TCO analysis determines all direct and indirect costs so clear pricing decisions can occur;
- **A *best value assessment***: The best value assessment goes beyond total costs to include decisions on work scope and pricing based on intangibles such as market risks, social responsibility, responsiveness and flexibility;
- **Underlying financial and operational assumptions**: Common assumptions include volumes, the costs of raw materials, market share estimates, currency assumptions and base exchange rates, inventory and workload mix;
- **Risk allocation**: Rather than shifting risk arbitrarily to either the buyer or the supplier, a pricing model seeks to jointly identify risks, understand the potential costs of those risks, determine which party is best suited to manage and mitigate each risk, and establishes an appropriate allocation of risk coverage (price-premium) for the party who agrees to bear the risk;
- **Desired *compensation method***: There is no one 'right answer' for selecting the compensation method for the pricing model; rather the objective is to create a flexible pricing structure that enables companies to use the method, or combination of methods, that best fits the nature of the work performed;
- ***Margin matching* triggers and techniques**: Margin matching is a mechanism designed to allow companies to fairly adjust prices based on movements in the defined underlying pricing model assumptions in response to specific market changes. The goal of margin matching is to avoid having one party 'win' at the other party's expense when 'business happens';
- **Contract duration**: Contract length is an essential element of a pricing model. Achieving step-level improvements can

take time and a significant investment on the part of the service provider. Longer-term agreements enable a supplier to amortise these investments over the life of the agreement;
- ***Incentives***: Coupling incentives to business agreements is not new, but it is not common either. It is also easier said than done. The key is to design the right mix of incentives that align interests. Companies should incorporate incentives mutually beneficial to the parties to offset the flaws of using conventional compensation methods.

So, when should you shift from using a *price* to a *pricing model*? As a general rule of thumb, use a price when you have a transactional sourcing business model and use a pricing model when you work with a more strategic performance-based and outcome-based Vested sourcing business model.

The business exchange in a transactional deal should be simple and predictable (eg janitorial supplies in an office environment) and as such there is likely little room for the supplier to create value beyond simply acquiring the good or service. While a price (eg gross maximum price) approach can be used in a performance-based deal, we prefer the use of a pricing model for performance-based contracts unless what you are buying is predictable and smaller in scope.

Companies should shift to a pricing model when the work is more complex and/or highly variable, or there is a higher likelihood of creating value by collaborating closely with suppliers (eg reducing costs, innovating, global or regional IFM scope).

WHAT COMPENSATION METHOD IS BEST — FIXED PRICE OR COST PLUS?

No matter which is used — a price or a pricing model — companies must determine the appropriate compensation method. A *compensation method* is the mechanism that a buyer uses to trigger payment to the supplier. Most companies rely on one of two compensation methods for their business arrangements: *fixed price* or *cost reimbursement*. In each case, the buyer is expected to pay the supplier for its costs and an acceptable profit margin. These two compensation methods have *inherent perverse incentives*. Each is discussed below.

In a *fixed price* compensation method, buyers and suppliers agree in advance to a price per unit of activity. The fixed price may relate to an individual transaction (eg price per call, per minute, per full-time equivalent, per hour, per unit, per shipment, per square foot, etc.) or to a set of transactions bundled together (such as a fixed monthly management fee). A guaranteed maximum price (GMP) deal follows this logic to the extreme.

A *cost reimbursement* compensation method pays suppliers their actual costs in performing a service and then compensates the supplier for overhead and profit through payment of some form of markup. The markup can be a percentage (cost-plus) or a fixed fee (often called a management fee).

Most complex deals use a variety of pricing mechanisms. Highly variable activities (such as infrequent project management services) are often priced as a fixed unit price (price per sq. ft as a % of construction), while predictable actions requiring dedicated staff (such as ongoing move-add-change staffing) are more frequently priced on a cost reimbursement basis. The key is to determine which is the right pricing mechanism for each type of service.

There are pros and cons to each mechanism. Fixed pricing, when applied correctly, provides the buyer with a clear, predictable price of cost for the planned services. The risk of performing lies with the supplier. If the supplier improves efficiencies their profit margins rise. If they perform inefficiently (in a true fixed price) their margins fall; however, many fixed pricing constructs fix only one aspect of the price. For example, in a fixed price per hour model, the risk lies with the client, as a supplier is not incented to perform quickly or efficiently, unless there is a separate cap or benchmark used to measure efficiency. A fixed price method is best used when budget predictability and administrative efficiency is more important than pricing accuracy.

One concern of a fixed price method is lack of transparency. Once a fixed price is agreed, the supplier is under no obligation to share with the client the composition of the charges. For many organisations this drives a level of mistrust and concern.

In addition, a fixed price does not work well in a highly changeable environment. Simply put, it is impossible to predict every reality in a complex agreement. As such, the supplier is forced to price-in 'worst case' scenarios to compensate for their risk. If the worst case does not happen, the supplier keeps the margin priced to cover it. This would be fair if they also covered the cost of any unexpected occurrences without asking for additional compensation; however, experience demonstrates that suppliers almost always go back to the client to request additional compensation to cover extraordinary expenses. For example, in a multi-million square foot portfolio based in the northeast USA, budgeting for snow removal is an educated 'guesstimate'. A supplier will look at historical snowfall averages and include a cost to ensure they can clear those amounts and then add a contingency buffer. If in any given year, instead of the average 100″ of snow, the region experiences minimal activity, the supplier will not step forward to offer a price reduction because it snowed only 25″. If the region is hit by 200″ of snow, however, the supplier will typically request an increase in compensation to cover the overage as it was out of their control.

Proponents of a fixed price/GMP deal will often say, 'well that is not a true GMP or fixed price deal'. While they are right, many suppliers can only absorb a limited amount of extraordinary expenses before their margins are diminished or eliminated. In a low margin business such as facilities management, a fixed price approach often pressures the supplier. A supplier who loses money will find other ways to cut costs and protect their margins, often to the client's detriment.

Under a cost reimbursement method, when structured correctly, the risk is more evenly shared. Suppliers develop an annual budget based upon expected volumes and activities. If snowfall totals are above or below budgeted expectations, the supplier passes through the actual cost of the snow removal, and the risk falls (as it should) to the client. This model provides increased transparency of underlying cost structures. Transparency brings many benefits, including creating a more fair and accurate way to measure cost savings. Transparency also makes it much easier to identify opportunities for cost reduction, because the underlying cost drivers are visible.

One downside to a cost reimbursement method is that it may encourage suppliers to be careless in managing costs. Why? Suppliers that overspend, increase the scope and scale of work, or deliver more services than may be needed are unfortunately rewarded with additional profit. Sophisticated benchmarking, cost accounting and productivity tracking can help mitigate this risk.

Remember that even with a reimbursement model, there is some aspect of fixed price. Whether it is a markup or a management fee, the supplier needs to be compensated for their profit and overhead. How best to determine what the price, fee or markup should be is often addressed via a competitive bid; however, it can also be derived through direct negotiations with your preferred supplier. Concerns about market competitiveness can be addressed through benchmarking or use of a standing neutral or independent advisor.

One way a buyer can mitigate risk in both the fixed price and cost reimbursement models is to include key performance metrics or service level agreements (SLA) that define target levels of quality expected for the price paid. These SLAs or metrics are mechanisms that buyers can employ to ensure they get what they pay for. If a supplier's performance is sub-par, the portion of the at-risk fee that is payable for achieving targets would be reduced to account for sub-par performance. Use of an at-risk fee is quite common in performance-based deals; however, if used, care needs to be taken to ensure that the metrics are appropriately structured to drive desired behaviour.

Another common structure in use today is an evolution in fixed priced compensation methods, whereby a supplier typically guarantees a fixed fee with a pre-agreed price reduction target (eg 3 per cent year-over-year price decrease) on the assumption that the supplier will deliver on productivity improvements. These guaranteed savings are often called a 'glidepath', because the buyer will see an annual price reduction over time.

On the surface, the glidepath approach appears to be a good deal for the buyer, since it shifts the risk to the supplier as they guarantee savings. Essentially this is a 'bet' by the supplier at the beginning of a contract term that it can drive improvements over the guaranteed savings. If it does, the supplier will reap the benefits — with the potential for surprisingly high margins. The positive is that the buyer enjoys certainty. The negative is that if the supplier cannot achieve those savings, neither party is happy and, as noted previously, when a supplier faces declining margins, they will make themselves whole through a variety of tactics.

SHOULD I USE AN OPEN OR CLOSED BOOK APPROACH? AND WHAT ARE THE BENEFITS?

There are degrees of 'open' and 'closed' book approaches. In a true fixed price structure, the supplier's books are completely 'closed' to the buyer. The supplier quotes a price. Inherent but invisible within that price is the supplier's underlying costs for labour, materials, equipment, subcontractor expenses, corporate overhead and profit. The supplier may choose to document some assumptions they have made to place boundaries around what is included in the fee (and therefore what is excluded). Commonly, though, the buyer does not see or understand what the supplier's true cost drivers are.

In a cost reimbursement pricing structure, the books are more 'open'. The buyer provides detailed documentation relative to the costs of labour, subcontracted expense, materials and other items they wish to pass through for reimbursement. Depending upon how the override or management fee is quoted, however, the supplier may have 'closed' books relative to things like the actual burden rate for staff, any markup on costs, corporate overhead charges and profit margins.

Truly open book approaches are transparent and allow a buyer and supplier to build a fact-based discussion around actual costs for both sides. The parties agree to reasonable profit margins for the supplier and strive to manage the total cost across the delivery stream effectively. The primary benefit of an open book approach is that it enables both companies to understand the actual total cost of ownership and allows them to shift their focus to working collaboratively to eliminate non-value-added activities, duplicative efforts and risks that drive up costs.

True open book pricing requires a high level of trust between the parties and a willingness to be fully transparent. Although many companies see the value of this transparency, actual execution across the supplier and buyer organisation can be difficult to achieve given corporate constraints.

HOW DO I CALCULATE A 'BEST VALUE' PRICE?

As mentioned above, a *best value assessment* allows you to understand a fair price for the supplier based on intangibles such as market risks, social responsibility, responsiveness and flexibility. A good best value assessment allows you to compare various suppliers to determine which supplier provides the best value for your money.

Common best value criteria include:

- Environmental sustainability;
- Diversity programme excellence;
- Social responsibility;
- Business interface efficiency;
- Market penetration;
- Brand image;
- Speed to market;
- Market dominant supply chain;
- Competitive market advantage;
- Technological advancement;
- Innovation;
- Cultural competence;
- Growth capability;
- Cash management.

There is no formal way to measure the adoption of Best Value (BV) concepts; however, we can look at public procurement law to indicate a trend. For example, the US Government's Federal Acquisition Regulation (FAR) is the uniform policies and procedures manual for all Federal acquisitions. FAR (section 15.101-1: Tradeoff Process)[1] states:

> 'A tradeoff process is appropriate when it may be in the best interest of the Government to consider award to other than the lowest priced offeror or other than the highest technically rated offeror [...] This process permits tradeoffs among cost or price and non-cost factors and allows the Government to accept other than the lowest priced proposal. The perceived benefits of the higher priced proposal shall merit the additional cost, and the rationale for tradeoffs must be documented.'

While country, state and local laws vary, most are making the shift to allow for Best Value pricing. For example, in 2001, the state of Minnesota enacted Statute §161.3410 that infused BV discretion into their procurement process.[2]

Even though the law allows for BV pricing, many procurement professionals are hesitant to use a BV approach — for example, BV was only used six times in Minnesota between 2001 and 2009. It has grown in popularity, however, after the highly successful Minnesota Department of Transportation (MnDOT) construction project for the I35 bridge replacement after the sudden collapse in 2009.

The result of the bridge project was spectacular. Even though MnDOT selected a contractor with the highest price, they received the overall Best Value — resulting in one of the most successful bridge construction projects in history. The bridge was erected in a staggeringly short timeframe of less than 12 months and won dozens of awards. A University of Tennessee case study on the MnDOT project provides a detailed review of how MnDOT applied BV supplier pricing for selecting the most appropriate supplier to rebuild the I35 bridge.[3]

The MnDOT example — like all good BV assessments — ensured transparency and objectivity in the selection process (see Figure 1), MnDOT listed selection criteria for every stage of the process and provided the evaluation weight of each criterion. MnDOT transparently outlined the performance criteria for selecting a contractor by

BEST VALUE SELECTION PROCESS

Design Build A + B, Best Value Formula

Three Components

- "A" = Contract Bid Price
- Plus "B" = Number of Days to Complete Project, which is multiplied by $200,000 per day - $200,000 per day based on 50% of road user costs
- Divided by Technical Proposal Average Score

Result: Adjusted Bid = **(A) + (B X $200,000) divided by TPA**

CONTRACT AWARDED TO LOWEST ADJUSTED BID

Figure 1 MnDOT BV selection process[4]

clearly documenting the formal evaluation criteria and evaluation process. The contractor whose proposal scored the highest according to the weighted criteria won the award.

MnDOT determined the BV price by combining three components: price, days to complete the project and technical score (eg quality).

The technical score was determined based on nine criteria across four main themes of quality, aesthetics, enhancements and public relations.

Quality (50%)
- Experience and authority of key individuals (20%)
- Extent of quality control/quality assurance (10%)
- Safety (10%)
- Measures to evaluate performance in construction (10%)

Aesthetics (20%)
- Enhancements to the request for proposal (RFP) (10%)
- Approach to involve stakeholders (10%)

Enhancements (15%)
- Geometric enhancements (10%)
- Structural enhancements (5%)

Public relations (15%)

TOTAL 100%

Use of BV (vs only price) enables an organisation to shift beyond price to the value a supplier can bring; however, it means you need to be smart about the weighting criteria — for example, how much will 'price' still count and how much will 'quality' count in the equation?

A second example comes from Vancouver Coastal Health (VCH), which decided to use a BV to select a supplier to perform environmental services across the region's health care operation (hospitals, nursing homes). The 'Mutual Value Request for Proposal' included a down-select process and final selection process, both based on BV. Figure 2 provides an excerpt from their RFP for the initial down-select, showing the price was valued at 10 per cent.[5]

Each proponent's concept proposal and concept presentation will be evaluated against the desirable criteria set out above. Upon completion of the evaluation, the top two ranked proponents will advance to the MVS definition phase. If all three proponents achieve an overall evaluation score of at least 75 points, however, all three proponents will advance to the MVS definition phase.

While many organisations try to get it right, sadly many do not. A 2014 study[6] in the construction industry in the Netherlands shows that 58 per cent of all public tenders using the EU's best price–quality ratio

Desirable Criteria	Weighting
1. EVS concept	30
• How the concept addresses each component of the opportunity	
• How the concept addresses the business challenges, risks, and objectives	
• How the concept delivers the Service Outcomes	
• How the concept provides the needed flexibility and scalability for EVS	
2. EVS operations and transition	30
• Approach for providing the underlying infrastructure required for the concept	
• Labour strategy of concept — union strategy, staff retention, staff competency maintenance, staffing model, and staffing and supervision benchmarks	
• Commitment of proponent's staff to engage in the MVS process and the contract(s)	
• Approach to transitioning EVS and key success factors	
• Approach to meet customer needs during transition and minimise service impacts on customers	
3. Governance/EVS Standards	20
• Governance approach	
• Commitment to manage partnerships	
• Definition of success for a mutually beneficial long term arrangement for the EVS Project	
• How the concept addresses ongoing compliance to the EVS standards	
• Key issues and, to the extent that there are potential barriers, the resolution of such barriers, to complying with the approach to achieving a mutually beneficial governance model and complying with EVS standards	
• Proposed leading practices and benchmarks for EVS incorporated in the concept	
4. Risk and deal structure	10
• Key risks associated with the EVS Project and high-level approach to allocate, manage and mitigate risk	
• Areas where risk and reward sharing is envisioned	
• Proposed deal structure and supporting reasoning of such structure	
5. Economic model and indicative price	10
• Overview of proposed economic model	
• Benefits of the proposed economic model derived by the health organisations and the proponent	
• Flexibility of proposed economic model to handle changes in programme deliverables over a long-term contract	
• Issues and potential barriers to achieving the proposed economic model	
• Pricing approach	
• Indicative price (*see indicative pricing template*)	
• Financial assumptions in economic model and indicative price	

Figure 2 Excerpt from VCH Mutual Value Request for Proposal

(BPQR) approach has had a weighing for quality between 20 per cent and 60 per cent (so 'price' counted between 80 per cent and 40 per cent). On the surface, this sounds like a good approach — however, almost 30 per cent of all tenders which used BPQR put the weighing on quality between 1 per cent and 10 per cent. This means that although these organisations *said* they were using BPQR mechanisms, 90 per cent of the tender result was still based on price.

A University of Tennessee white paper on BV suggests one weight non-price criteria at least 60 per cent when using BV.[7]

One alternative to mitigate the impact of inappropriate weights on pricing is to use a price per quality point system (see Figure 3). This way, there is no need to arbitrarily weight price. Bids are scored based on

		Bidder 1		Bidder 2		Bidder 3	
Evaluation Category	**Weight Factor**	**Score**	**Total**	**Score**	**Total**	**Score**	**Total**
Company Profile	**15%**	90.00	13.50	88.00	13.20	86.00	12.90
Service Delivery	**25%**	87.60	21.90	80.10	20.03	80.50	20.13
Operational Plan	**20%**	92.40	18.48	80.00	16.00	78.50	15.70
Proposed Team	**20%**	88.70	17.74	77.50	15.50	77.00	15.40
Technology Solution	**20%**	93.20	18.64	81.50	16.30	78.90	15.78
TOTAL QUALITY SCORE	**100%**		**90.26**		**81.03**		**79.91**
Resultant Ranking		**1**		**2**		**3**	

Financial Bid - Grand Total	$10,680,349	$10,467,185	$9,999,849
Price Per Quality Point (total financial bid divided by the total score)	$118,329	$129,185	$125,147
Legal Evaluation	PASS	PASS	PASS
Reference Checks	PASS	PASS	PASS

Figure 3 Example of price per quality point methodology
Source: SIREAS, LLC

weighted quality or value criteria. Their price is then divided by the total value or quality score. The provider with the best price per quality point is then awarded the business. This method has been used consistently in corporate awards in the CRE space for more than a decade.

WHAT TYPES OF INCENTIVES CAN I USE?

Not all forms of compensation are pricing-based. In most complex CRE outsourcing relationships, buyers expect the supplier to deliver a level of savings, continuous improvement or even innovation; however, the pricing models used often compensate the supplier for their costs plus an agreed-upon margin and do not appropriately compensate for delivering enhanced value. A good way to mitigate this is to include incentives that will drive the appropriate behaviour.

An *incentive* is a reward for the supplier, used to encourage them to bring their best thinking, to generate savings and bring added value to the buyer's account. When speaking of incentives, most people think of *tangible incentives* given to a supplier for a job well done. Some of the most powerful incentives, however, are *inherent incentives*, meaning they are embedded into the overall framework of a buyer–supplier relationship through the contract structure or pricing mechanisms used. Inherent incentives can be powerful because they naturally drive behaviours between a buyer and supplier, often creating positive results. A good example of this is a longer-term contract, which generates an inherent incentive for a supplier to invest in the relationship as they will have a longer period of time to amortise the expense. If the overall contract is not structured properly, however, a long-term contract can also result in a supplier being lazy.

Unfortunately, many companies rarely realise that the inherent incentives they create through their contract structure, compensation method and pricing approach are *perverse incentives*. A perverse incentive is a direct negative or unconscious behaviour that drives unintended consequences. Using the example of contract term again, a very short-term contract will likely ensure that the supplier does not invest as much in the relationship, given their opportunity to recover any investment is so short.

Not all tangible incentives are monetary; however, many are. Below details some of the most common incentives used in CRE outsourcing deals.

Gain-share/cost savings incentive

Many organisations encourage suppliers to increase efficiency, eliminate non-value-added activities and reduce costs above and beyond the base level of performance required. In return, a percentage of the net savings generated is shared with the supplier for a finite period. While this can be very effective, it can also generate discord. Clear definitions of what constitutes savings, upfront agreement on percentages to be shared, joint understanding of when and how payouts will occur are all critical to ensuring a successful gain-sharing programme.

Pay for performance incentive

Typically tied to specific performance requirements, a *performance incentive* is ideally designed to increment the supplier's profit when they achieve specific targets. The incentive fee can be fixed or variable, but always corresponds to specific, agreed-upon targets. Performance incentives can be an effective way to encourage performance provided that the incentive is worth more than the effort to achieve it. Completion of an effective transition to the supplier, on time and on budget with minimal disruptions to the customer base is a common performance incentive in CRE outsourcings.

Award fee

Award fees are paid at the conclusion of a fixed-duration agreement for achieving a desired goal. Award fees can be fixed or variable and are typically used when the supplier's performance is not objectively measurable as it occurs, or when the nature of the work makes it difficult to devise objective predetermined performance incentives tied to cost or other performance indicators. Like performance incentives, for award fees to be effective, the value of the award fee must exceed the cost of achieving the result. A good example is the US Department of Energy's Rocky Flats closure project, which paid Rocky Flats an award fee upon the successful clean-up and closure of the Rocky Flats nuclear site.

Non-monetary incentives

Incentives such as public recognition, endorsements in public case studies, willingness to provide references, sharing processes and techniques, sharing knowledge and other goodwill gestures can be powerful, intangible incentives that increase visibility and market worth. Buyers and suppliers must be realistic, however, in evaluating the true worth of such incentives. A poorly positioned customer may not be able to provide valuable non-monetary incentives to a well-positioned supplier. On the other hand, a customer that is relatively small but well regarded in its industry may be very well positioned, particularly if its industry is one that the supplier considers strategic.

Award term (contract extension)

A great incentive for a supplier is more business (provided it is profitable business for the supplier). An *award term* is an automatic renewal/contract extension added when a supplier meets agreed targets. In some cases, especially Vested agreements, award terms are used to create a long-term 'evergreen' contract whereby the buyer automatically extends the contract. If a deal is distressed, an award term is an excellent incentive for a supplier to complete a 'get well plan' aimed at correcting the dysfunctional relationship.

Companies that want to include incentives should develop an *incentive framework*, which is a mechanism to measure performance and trigger incentive awards or payments. Using a clearly defined incentive framework will prevent frustration that often occurs between buyer and supplier.

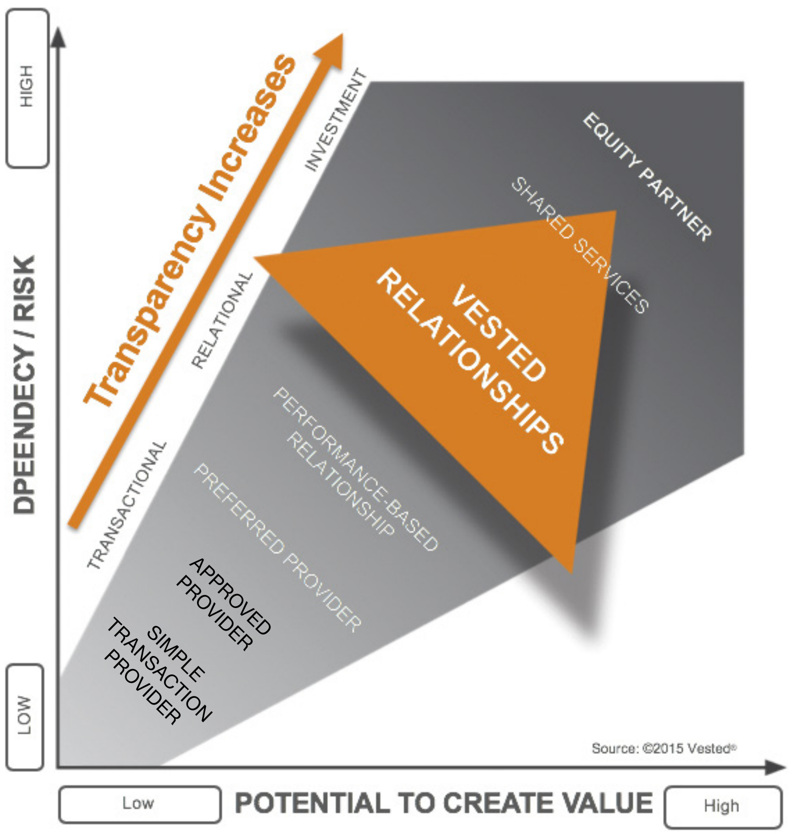

Figure 4 Relationship between transparency and sourcing business models
Source: University of Tennessee/Vested Outsourcing

A CALL TO ACTION — NEGOTIATE WITH A DIFFFERENT LENS

Disconnects over pricing can cause frustration, create a lack of trust in the relationship, increase transaction costs, or — worse — trigger hostilities that result in the termination of the relationship. In these circumstances companies should strive to negotiate pricing through a different lens — a lens that includes embracing transparency, cooperation and smart allocation of risk/reward.

Transparency is the open and timely sharing of information relevant to a party's ability to make wise decisions. Many companies espouse transparency, but most just seek to understand a supplier's costs — not the true total cost of ownership or value of doing business — together. Too often people succumb to the temptation to share only information that bolsters their position or that undermines their counterpart's position, while concealing information that exposes a weakness. The intentional concealment of some information skews the ability of others to make good decisions. It also reinforces people's beliefs that they cannot trust anyone at the bargaining table. By contrast, complete sharing is powerful, because it builds trust.

The more complex and dynamic your CRE environment, the more you should be open to shifting up the sourcing continuum to a more mature performance-based or Vested sourcing business model, underpinned by a transparent approach for developing a pricing model, with incentives designed to create value for both the buyer and supplier. Figure 4 shows the relationship between transparency and pricing approaches as they relate to each sourcing business model.

The dependency/risk and potential value from a strategic relationship demands that both parties begin to shift to a more transparent approach to pricing that shares all relevant information to help their partner make an informed decision.

While many companies understand the benefits of transparency, they fear an open book approach *because* they do not trust each other. Suppliers fear that exposing their costs and profit margins will give buyers power to whittle away their margins or use it to drive a bidding war. Buyers fear disclosing too much information will provide the supplier leverage to use against them in future negotiations.

One way to mitigate both fears is to develop a Statement of Intent[8] and Guardrails that outline each party's expectations of the other. Jeanette Nyden, Kate Vitasek and David Frydlinger advocate for this in their book *Getting to We: Negotiating Agreements for Highly Collaborative Relationships*.[9] A Statement of Intent and Guardrails should be developed early in the negotiation process; for example, the parties express such items as margin targets for the supplier, and other key assumptions. A proper job of setting margin targets early in discussions will make sharing costs and margins easier.

If complete transparency is impossible, share as much information as is feasible. Over time, as companies increase their level of trust, they can revisit and refine the price or pricing model. As a general rule, using a non-transparent, closed book approach is best for less complex sourcing business models, while more complex and dependent relationships seeking value and innovation should use a more transparent approach.

The bottom line? The next time you negotiate pricing of your CRE deal, stop and pull out this paper and ensure you are using all of the pricing tools in your toolkit.

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