VIEWPOINT ARTICLE

Facility Management Outsourcing:
Negotiating the Business Model

AGILEOAK

TABLE OF CONTENTS

EXECUTIVE SUMMARY

The complexities of a Facilities Management (FM) outsourcing deal require a well-negotiated contract between the Client (Facility Owner) and the Service Provider designed to address all probable issues which could occur during the course of the business relationship. The business model should ensure that the pricing structure is tailored to the nature of services being provided. Carefully aligned incentives should guide both parties to the desired business performance. Cost transparency, well-specified pass through costs, and the vigilant monitoring of both spending and non-invoiced Service Provider accruals by way of targeted contractual requirements are critical to success. Future services must be anticipated and priced in order to maximize the Client's upfront deal leverage. Receiving a service delivery proposal from a qualified Service Provider that addresses these business objectives is the first step to achieving these goals.

This viewpoint article discusses the nuances and best practices associated with constructing and negotiating an appropriate FM Outsourcing Business Model with the intention of maximizing cost efficiency and best aligning Client and Service Provider business interests. It is based on the author's ten years experience structuring and negotiating FM outsourcing agreements.

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DISCUSSION

The Business Model

The business model refers to the commercial aspects of an agreement between the Client and Service Provider. Negotiation of the business model is typically conducted by the Client procurement or strategic sourcing group, while negotiation of the contractual terms and conditions is usually driven by the Client's legal team. A high level of coordination is required between both groups. The business model includes several elements, but those which typically receive the most attention are pricing structure, over-run protection, deal margins, variable compensation, shared savings, and pricing for changes in portfolio and scope.

Pricing Structure

Most FM deals executed in today's marketplace follow a common pricing structure known as Guaranteed Maximum Price (GMP), or Pass-Through with Cap. It requires a Service Provider to pass all direct costs of FM service delivery through to a Client without markup. A separate fixed management fee (the "margin") is invoiced to cover account 'overhead' and Service Provider profit. A Service Provider is usually not allowed to pass-through any direct costs above the 'cap', although the strictness of this obligation varies.

Other alternative and supplementary pricing models include:

Indefinite Quantity or 'Unit Cost' Pricing: This model is effective when scaling a contract due to an uncertain purchase quantity. This ensures a degree of cost predictability and also lends itself well to benchmarking, but does not necessarily ensure the most efficient service delivery model. It is best used when the purchasing requirement involves standardized "units" of service delivery.

Fixed Price: In this model, the Service Provider performs all services at a fixed price. Any efficiency-related savings accrue completely to the Service Provider, providing an incentive for Service Providers to minimize service delivery in order to maximize profits. Fixed Price is appropriate for smaller scale jobs where price certainty is essential.

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Time & Material: Time and Material (T&M) pricing ensures easy comparison of labor rates, and is often the most flexible service delivery model. Service Providers prefer this model because it ensures a known margin for every hour worked, and as such, hours consumed must be carefully monitored to avoid cost escalation. T&M pricing is best used when the Scope of Work (SOW) to be provided is not yet clear and the expected volume of work is low.

A properly applied GMP model provides the Service Provider a guaranteed management fee with incentives for performance (Variable Compensation) and cost reductions (Shared Savings). The issues described below must be addressed for effective deployment of the GMP business model.

Allowable Pass-Through Expenses

It is important for the Client to clearly define allowable pass-through expenses. For example, a deal with a five (5) percent management fee may be more 'efficient' for the Client than a deal which is reported as having a two (2) percent management fee, but which allows the following items as pass-through expenses:

- Deal insurance.
- Centralized administrative costs (e.g. Invoicing costs or HR Costs)
- Costs associated with specialist resource support.
- Account management travel costs.
- License fees for Service Provider developed/owned software applications.

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While these expenses might be valid, their specific allocation to a Client can be somewhat subjective. As they are difficult to verify or audit, allowing them as pass-through expenses makes it hard to compare Service Providers. It may also distort the incentive model intended by the GMP deal structure.

Allowable pass-through costs should typically include such items as reimbursable personnel and employment-related costs, as well as budgeted expenses for the payment of managed third-party agreements. In general they are incremental expenses which are directly associated with the delivery of services to the Client and are subject to a clear audit trail.

Itemized Services

When revising their proposal to best meet Client needs, Service Providers may suggest, modify and retract aspects of their service delivery model. This series of evolutions can create Client expectations for services which may not be itemized in the final deal and which can often be modes of support found in the proposal, but not clearly described in either the Scope of Work document or the deal's budget worksheet. Ensuring accuracy and completeness of the final documentation is critical to success.

'Non-Controllable' Expenses

During contract negotiations Service Providers may have concerns that a number of services feature 'uncontrollable' demand. They then ask that these services be exempted from the maximum price controls. Unfortunately, removing price controls might also reduce a Service Provider's incentive to manage and deliver services efficiently.

The broader the scope of work, the more reasonable it is to expect a Service Provider to accept risk for 'uncontrollable' services. When there is a larger portfolio of services, the risk of a single event in one area resulting in general price over-runs is greatly reduced. Service Providers can also use a broad relationship with a Client to influence Client behavior and reduce the Client's controllable cost drivers.

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‘Capital’ Repairs

Equipment repairs over a certain value are usually treated as ‘capital’, exempting them from the maintenance budget. This definition of capital makes sense from a financial perspective, as it enables favorable tax treatment. However, it can also work to reduce Service Provider performance.

Reducing routine maintenance of certain types of assets can generate apparent cost savings for several years until premature asset failure occurs and a full overhaul is required. Major rebuilds can easily exceed the typical cap for ‘capital’ repairs. This creates the unintended effect of rewarding a Service Provider for shifting relatively modest maintenance costs to large deferred capital expenses. Contractually requiring the Service Provider to provide base levels of maintenance activity and requiring the investigation of any end-of-life asset events can help resolve this problem. This also makes the Service Provider responsible for the total cost of ownership, and helps both parties maximize asset life while avoiding false savings.

Employee Benefits

The structure used to reimburse Service Provider employee benefits can significantly impact the margins realized by Service Providers. Service Providers often charge a fixed amount for benefits, which may create a source of hidden Service Provider revenue and reframe the business model as ‘Time and Material’. This occurs because fixed benefit loads are usually conservatively assessed based on the most expensive benefits user, even though benefit loads can vary widely. In addition, Service Provider overtime magnifies this effect, as these hours are often treated the same as base or “straight-time” hours. Aligning benefits to actual costs ensures that the deal stays true to intended GMP principles.

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Comparable bids can be ensured in the face of an unknown benefit load in advance of hiring the workforce by:

- Service Providers assuming that all employees will take maximum benefits, thus establishing a single, consistent point of reference for bid assessment purposes.
- All wages and benefits are to be passed through at actual cost for invoicing purposes.
- The GMP being adjusted for the difference between the full and actual benefit load.

Over-Run Protection

Clients often indicate that they are concerned that the Service Provider will earn 'excessive' shared savings. The greater risk, however, is that a Service Provider will over-run the budget and then seek relief.

Common methods in contracts to prevent overruns include requiring the Service Provider to:

- Absorb all over-run costs up to a specific amount that is equal to their management fee.
- Seek permission from the Client prior to any over-run costs.

While essential, experience shows that these provisions are not sufficient to fully deal with the issue, which is usually operational rather than contractual. Significant cost over-runs may not become apparent until well after the conclusion of the contract year in question. Most Clients in this situation move to preserve the relationship by offsetting some of the Service Provider's cost absorption responsibility. To prevent this, provisions in the contract should be added which ensure that a Service Provider:

- Includes monthly spending projections as part of the annual budget process;
- Reports quarterly financial performance against a budget which considers all service delivery costs, including invoiced services and accruals;

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- Explains all budget variances and takes proper corrective actions for over-runs.

This ensures that there are on-going processes in place to support the Service Provider's obligation to operate within budget.

Deal Margins

Achieving 'efficient' deal margins in the FM industry has become a badge of honor. However, the reported deal margin is often subjective and thus not always a useful measure of efficient pricing.

Clients should ensure that the complete fee and cost picture are understood before negotiating. Services managed by Service Provider personnel but paid directly by the Client (agency spend) should not factor into the calculation of the management fee. Service Providers who act as integrators and not self-performers often seem to have lower fees. This view often does not consider that many services may be delivered by subcontractors without fee transparency to the Client. The implied margin associated with the Management fees should be based on the Service Provider's pass-through spending, which may not always equal the total annual "deal value".

How a Service Provider evaluates account profitability is important for the Client to understand. There can be greater emphasis on the Service Provider meeting Return on Invested Capital (ROIC) goals rather than margin requirements. Understanding this and working with the Service Provider to lower their capital investment in the relationship can often help lower margin expectations. Some Service Providers have become habituated to renegotiating deal terms after the contract is executed. To maximize leverage, it should be stressed that the Client will not be prepared to offer better payment terms after a contract is signed.

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Variable Compensation and Shared Savings

With a well-designed GMP pricing model, a Service Provider's incentive comes from 'Variable Compensation' and 'Shared Savings'. 'Variable Compensation' refers to fees earned based on performance, while 'Shared Savings' allows a Service Provider to maximize revenue by under-running the budget.

Variable Compensation

The two main challenges of 'Variable Compensation' are ensuring that the compensation model is tied in with performance and tuned to a Service Provider's motivations. Most 'Variable Compensation' schemes use Key Performance Indicators (KPIs). KPIs are then used to calculate variable compensation based on a simple formula, with each Indicator assigned a specific compensation ratio.

This simple 'ratio' approach can presents several issues for a Client:

- The Service Provider can experience major service delivery failures yet still receive large incentive payments.
- The breadth of the program may not foresee actual failure modes.
- Sustained poor performance might not be recognized.

It is essential to negotiate a Variable Compensation model which recognizes that under-performing KPIs are typically more important than over-performing. The "Credit Method" ensures this. Giving a credit value to each KPI allows a Service Provider to earn credits while:

- Providing a clear picture of where obligations are not being met, and
- Assigning more important indicators a higher credit value.

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This approach uses the total number of earned credits to calculate the variable fee awarded to the Service Provider. Equally important is having mechanisms for the Client to change KPI's and target levels of performance over time. This enables the deal to adapt to evolving business pressures and previously unanticipated performance issues.

A greater challenge is creating an incentive program which can motivate a Service Provider. Each Service Provider values incentive compensation and considers risks differently. During the sourcing process, and especially during negotiations, a Client must be sensitive to which aspects of 'Variable Compensation' most interest a Service Provider. Clients must also examine any counter-proposals from both a margin and ROIC perspective. This will help the Client identify the deal targets that Service Providers are seeking to optimize and provide the insight to help tailor the most appropriate pricing and 'Variable Compensation' structure.

Shared Savings

Most Shared Savings programs operate on a run-rate reduction basis. If the total cost of services delivered is below budget, a Service Provider shares a portion of the savings in exchange for proportionally reducing the budget target the next year. Typically, shared savings only apply in the year they are first achieved. A Client's ability to manage and pay the agreed-upon incentives and shared savings can be as important as their incentive value. Many different levels of shared savings can be offered to Service Providers, stretching from ten (10) percent to one hundred (100) percent.

Pricing for Changes in Portfolio and Scope

Most deals evolve over time. The optimal SOW evolves with business needs and Service Provider capabilities. Effective deals anticipate likely changes as well as assume a pricing model to take advantage of the Client's deal leverage before a contract is signed. This is particularly effective because a Service Provider can make generous concessions to 'close the deal' without having any impact on near-term deal margin.

The key to doing this effectively is to ensure that there is strong link from the proposed cost drivers to the pricing. In addition, creating a pricing structure for unplanned extra services can be used ensure that these services will be provided at a market competitive margin

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