

Best Practice

Pricing Strategies for Term Maintenance Contracts (Part 2)

In Part 1, we discussed Schedule of Rates, Open Book and Cost Plus pricing mechanisms. In this issue we are going to focus on the following:-

- Fixed Price
- Target Cost
- Hybrid pricing

Fixed Price – This type of pricing mechanism is particularly effective where the scope of work is clearly defined, the condition of the asset is known and where the transfer of risk to the contractor is not too great to render pricing unrealistic or unsustainable. Fixed price by its nature requires the contractor to provide a fixed price for the delivery of services where the risk of delivering the service is completely transferred to the contractor. The Contractor will undertake the work for the fixed price, regardless of the cost. Typically, fixed price contracts have been used in term based contracts for services such as gas servicing and maintenance, most commonly referred to in the industry as a “3* comprehensive service”. Under these contracts, the contractor warrants to service, maintain and repair gas appliances for a fixed annual charge. Increasingly, these types of contract are being used on other term contracts such as day to day repairs and maintenance and void repairs. The problem is that in order to arrive at a reasonable fixed price, the contractor needs to have good asset information such as historical data on repairs spend, the frequency and nature of repairs and stock condition information. For more complex term contracts, a period of delivering the service under a more traditional pricing mechanism is usual, before moving towards fixed price. On the plus side, once the fixed price has been established, it can offer major advantages in terms of cost certainty for the client and improved efficiency through reduced administration.

Target Cost – This is where the contractor and client agree to work to a ‘target cost’ for the delivery of a task(s) or project. The target cost could be built up either on an ‘open book’ basis or the use of some other form of pricing mechanism such as a schedule of rates. When the task(s) is complete the ‘actual cost’ of undertaking the task is calculated on an ‘open book’ basis. Essentially, the difference between the actual cost and the target cost is then subject to a pain/gain share mechanism. Therefore, in simple terms if the actual cost is less than the target cost, then the client and contractor agree to share the saving (gain) at the pre-determined allocations. Equally, if the actual cost exceeds the target cost, then the client and contractor agree to share the loss (pain). This type of price mechanism is more appropriate on term contracts where the task is more complex or of a higher value, such as the installation of a kitchen or bathroom. The advantage of using ‘target costing’ during the delivery of the term programme can reduce administration and focus the team on delivering the work and improving efficiency.

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If linked with a pain/gain mechanism, there can be considerable advantages by incentivising the contractor to save costs, yet realise financial benefits of doing so.

Hybrid Pricing – This is largely what it says, i.e. a combination of different pricing mechanisms. Essentially, the pricing mechanisms used within a hybrid arrangement will depend on the nature of the work and the balance of risk. For example, on a contract for day to day repairs and voids, it might be possible to utilise a variable pricing mechanism for day to day repairs such as a schedule of rates and a fixed pricing mechanism for void repairs. The combination of different pricing mechanisms needs to be complementary and easy to administer. Therefore, different cost heads for on-costs such as site overheads, central office overheads and profit, need to be consistent across different pricing mechanisms. Hybrid pricing can also be used when a phased transition to a new price mechanism is anticipated. For example, a fixed price mechanism can be used from the start of the contract for certain elements, with other elements, subject to, say, a schedule of rates, with a view to moving to fixed price later on.

Ultimately the choice of pricing mechanism to use on term based contracts will depend on a number of factors including: risk, client budget, condition of asset and market conditions. Of most significance at the moment is 'market conditions'. Whilst clients may be keen to take advantage of a competitive environment by market testing their term contracts, by their very nature, term contracts are generally longer term (minimum of 3 years usually). Therefore, it is important that contracts entered into now are sustainable and are not designed to take short term benefits, which from experience suggests that the long term will be affected.

It is also worth considering the type of contract that best supports different pricing mechanisms. Both the Term Partnering Contract (TPC2005) and the NEC3 Term Service Contract are extremely flexible in how pricing frameworks can be used on term based contracts.

Finally, we are delighted to offer training seminars on Pricing Strategies and Open Book methodologies. Our training sessions can be tailored to your specific needs whether you are a client, consultant or contractor seeking a greater understanding of the key issues.