

Service Contracts – What is the Right Price?

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Abstract.

Corporations look to supply chain management to ensure that value is received for each dollar spent in service contracts, just as in commodity procurement. However, procurement of services is distinctly different from the procurement of goods. How can we establish what is the right price for a service contract? Is there a price analysis methodology? Is there a strategic negotiation strategy on how to negotiate “inside the price rate”? Is there a methodology to identify these price components? Once we understand how the bill rate is compiled, we have points to negotiate.

Objectives.

Over the past several years, purchasing departments have increasingly moved from strictly procuring goods to the tasks associated with procuring services. We select a service provider; draft a contract; write a statement of work; and manage the service agreement. Service contract providers quote by billable hourly rate, flat rate, time and materials, cost plus, etc. But, what is the “right” price? We will introduce a price analysis methodology and a strategic negotiation strategy on how to negotiate “inside the price rate”.

Contracting for services is similar to purchasing goods in some ways. We follow a traditional sourcing purchasing process; look to leverage supply and demand of the market; and realize that it requires both sourcing experts and organizational subject matter experts. It also requires a solid contract with specific deliverables and it requires regular reassessment of contracts.

However, there are ways that buying services is different from buying hard goods. It can be difficult to write a comprehensive statement of work, bad service is not “returnable”. It requires more subjective decision criteria and background checks or security concerns often must be addressed. In addition, service contracts are not covered by the Uniform Commercial Code (UCC).

Successful service buyers need certain skills. We need analytical, negotiation, project management, verbal and written communication skills. We need the skills to create a detailed Statement of Work (SOW). We also need a subject matter expert (SME) on the team who knows as much or more than the service supplier.

The ultimate objective is to maximize the value of each professional service dollar spent. We buy services based on a combination of price and the intrinsic value that the service provides.

As buyers, each of us weighs the importance of intrinsic components differently. The same service may be worth more to you than to me, even though we paid the exact same price.

Intrinsic Value Components might include:

- Reputation of the Firm
- Location of Supplier
- Service Received During Sale
- Ease of Purchase
- Customer Support after Sale
- Quality of the Individual(s) performing the service
- Supplier Diversity
- Political or Community Considerations
- Many Others

There are three basic concepts for negotiations. Increase “what you get” while keeping “what you pay” constant. This strategy is to negotiate to receive additional goods and services at no additional cost. Another is, to keep “what you get” constant and reduce “what you pay”. This approach is traditional sourcing. Get the same for less. The third method is to increase “what you get” at a more rapid pace than “what you pay” for it. Over time, prices tend to rise. If you pay 3% more, get 4%+ more.

The main focus of this paper is Service Contracts Pricing and Evaluation. We will introduce how we can identify the real components of the bill rate and then how we can evaluate it. Then we can use this knowledge to develop a strategic negotiation strategy.

The following concepts will provide a guide and checklist for Service Contracts Pricing and Evaluation:

- The primary key is to do a price components breakdown analysis. Determine just what the individual components might be by individual service type. Start with wage, tax and benefits. Define individual benefits, e.g., how many holidays, how many vacation days, company pay and employee pay benefits. What else is included in the rate? Specify overhead, insurance, workers comp, vehicles, equipment, travel, training, uniforms, finance, miscellaneous and profit. What is included in General and Administrative (G&A)? If you were bidding on your service contract, what would you include to create your billable rate?
- Next, develop templates for what you buy. Create a template of these components for each general type of service, i.e., security, janitorial, landscaping, temp service, waste removal, machine maintenance, etc.
- Incorporate your template into the RFP to define specs and cost components. Have the bidders complete your costing template in their RFP responses. Request the bidders to break down their costs by adding any other categories to your template.
- Create a decision-making and bidder response matrix to evaluate the bids received. Most successful organizations use a system of identifying musts and wants, weighted by importance.

- Educate your team through benchmarking for standard pricing/value. Do your homework. Many websites and organizations exist that may be researched by industry standard labor rate, square foot, job code, union contract, trades, classification, etc. Know the ranges where you can negotiate, just like in commodity purchasing.
- Determine the value of longer terms contracts. You don't necessarily have to reevaluate each year. A supplier can amortize costs over several years. A multiyear agreement may provide visibility to cost increases long term, i.e., low initial price - high maintenance in the later years. Know the value to suppliers of stable business.
- Don't forget the overtime rate myth. Overtime pay might be 1.5 times the regular pay rate. What is the billable rate for overtime? Is it 1.5 as well? Are all costs 1.5 more or just wages? This may be a good negotiation point. Most suppliers will bid a billable rate of 1.5. It is up to you to be knowledgeable; know the component parts of the rate; and negotiate accordingly. Through negotiations, the overtime bill rate might be 1.4 or 1.3 or even 1.2. It will all depend on the type of service; the amount of overhead verses the wages ratio; and, of course, your negotiation skills.
- Identify the cost savings methodology your team may employ. Is it budget cost down; cost avoidance; negotiated savings, or something else? Is it all about price or is it also about procurement effort? I like to recognize effort while most budget analysts want only dollars removed. Knowing your target makes aiming and hitting much more realistic.
- After completing your template, develop a strategic negotiation strategy for each component, just like parts of a supply chain or analysis of goods pricing. Once you have identified each component piece of the bill rate, you may then turn each one into a negotiation point. You will have strength through knowledge. Where can you add value? Which parts can you leverage to reduce costs? Could you leverage insurance, office supplies, shipping costs, copier machines, uniforms or anything else?
- Change the shape of the board, the field or the game. Which provides more advantage to you, the mark up or direct labor ratio? Let's review the difference.

Mark Up vs Direct Labor Ratio

Contracts can be priced as a percentage of Direct Labor (DL). DL is what the employee is paid. Result: the higher the DL, the lower the mark-up.

Example:

Percentage of Direct Labor (DL): 66.5%
 (\$12.50 wage divided by .665 = \$18.80 billable rate)

Mark-up = 50.4%
 (\$12.50 times 50.4% = \$6.30 + \$12.50 = \$18.80 billable rate)

Look at three bids, in percentage of DL

Company A: 64.98%

Company B: 66.66%

Company C: 68%; successful bidder

The lower the percentage of DL, the more expensive it is for you.

Knowing the difference can position you for an interesting negotiation discussion with your supplier. How much of the bid is wage and how much is everything else? Do you want to pay for the quality of those doing the service or do you want to pay for high overhead costs? How much quality do you need? What parts of the overhead can you affect for cost reductions?

In summary, "What is the Right Price?" It is "The Lowest Total Cost, at the Highest Intrinsic Value." It is all about learning how the supplier puts his billable rate bid together and how you can add value by working with him to reduce his costs, and yours.

REFERENCES:

Website references:

Institute for Supply Management (ISM), <http://www.ism.ws>

CAPS, Center for Strategic Supply Research, <http://www.capsresearch.org/>