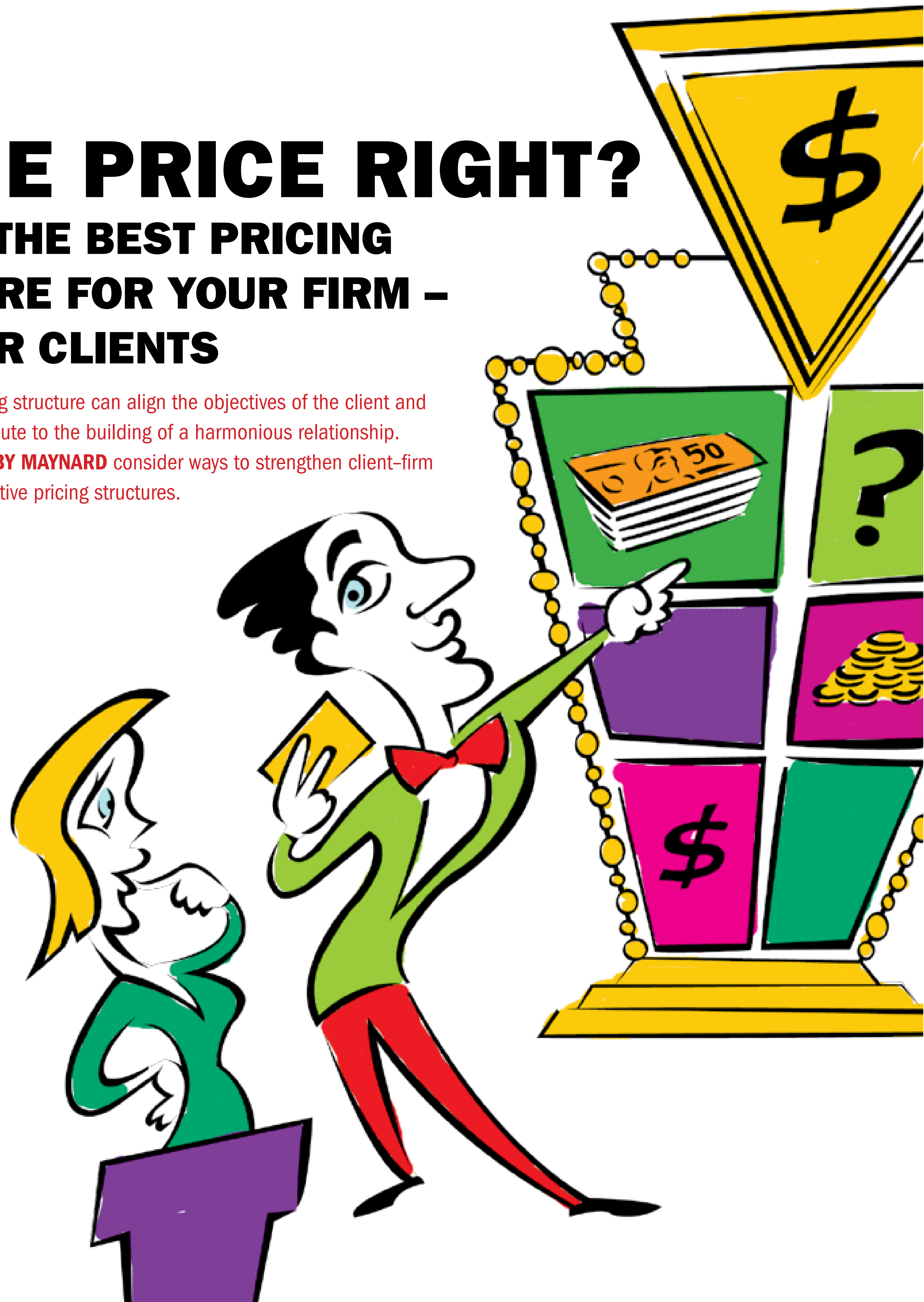
IS THE PRICE RIGHT?

FINDING THE BEST PRICING STRUCTURE FOR YOUR FIRM – AND YOUR CLIENTS

Choosing the right pricing structure can align the objectives of the client and the firm, and can contribute to the building of a harmonious relationship. **COLIN JASPER** and **LIBBY MAYNARD** consider ways to strengthen client–firm relations through alternative pricing structures.



The marketing director of a large law firm was recently bemoaning the lack of innovation shown by firms in the area of pricing. He spoke with passion of clients' desire for more innovative approaches to pricing and with frustration at the ability of major firms to deliver truly enhanced pricing outcomes. He noted how firms were willing to entertain alternative models such as fixed fees or success fees, but highlighted that these simplistic offerings did not really address the underlying client needs.

The push for better-aligned pricing structures has been running for many years, yet still only pockets of change are apparent. In our view, two major barriers exist in the development of better pricing structures:

1. **The need to work together.** Both firm and client need to come to the table and have pricing discussions that are exploratory in nature rather than adversarial.
2. **A clear understanding of the fundamentals.** As with any discipline, innovation should be built off a solid understanding of the fundamentals. While it is easy to point out the short comings of various pricing structures, few practitioners have sought to truly master the concept of alternative pricing structures, their pros and cons, when to use them and how to manage them.

This article aims to assist firms and clients develop a stronger understanding of the underlying principles of the core pricing structures used in the professions to aid exploration and innovation.

PRICING 101

Setting pricing is a fundamental challenge for any firm, and is influenced by a number of factors, including:

- what it costs to produce a service
- what clients are prepared to pay for it
- the price that competitors are charging for it
- constraints imposed by outside agencies.

The cost of producing the service is the minimum price that an organisation would be prepared to accept over the long term. The maximum price achievable is that which clients are prepared to pay for it. This is influenced by the notion of value, the level of competition and, if applicable, government regulation, and translates into the following primary pricing methods.

Cost-plus pricing – Prices are easy to calculate using this method and it allows for delegation of pricing. This method does not, however, take account of the competition or the fact that some clients value the same service more highly than others. The method of producing the service is a factor influencing this, which has seen the development of new organisational models for professional service firms designed to minimise costs.

Value-based pricing – Different clients put different ceilings on the price of a service depending upon the value they place on it. Value-based pricing is dependent on effective segmentation. Some segments will be price sensitive, whereas others will be prepared to pay for a service that is differentiated. The intangible and inseparable nature of services makes it possible for price discrimination between different groups of users.

Competitor-based pricing – There are few situations where the activities of competitors can be ignored. The price adopted vis-à-vis competitors' offerings also impacts on perceptions about quality and the way in which a service is promoted.

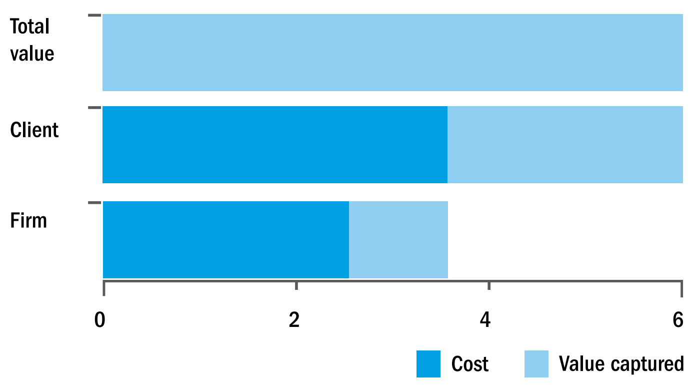
While these are presented as three distinct methods of pricing, in practice all three methods should be melded into one. It is sub-optimal to develop prices without considering costs, client value and competitors.

FINDING STRUCTURES THAT ENHANCE VALUE

Of the total value of a project, the value captured by the client will be the total value minus its costs, including the cost of service providers (the price charged by the firm). The value captured by the firm will be the price paid by the client minus the cost of producing the service.

Figure 1 illustrates this concept. The greater that the cost of using the firm is as a percentage of the total project costs or value, the more significant will be the impact of the chosen pricing structure.

Figure 1 – Value captured by client and firm



While lawyers have been overly reliant on the billable hour, other professions have tended to adopt one or two approaches to pricing almost to the exclusion of all others (e.g. retainers in PR, fixed fees in engineering, percentage of transaction in merchant banking, unit rates in patent registration).

The adoption of these pricing structures by different professional service firms is often historical and based on some sound logic, but as a pricing structure becomes standard, many

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firms are reluctant to use other less familiar options as they involve adopting different levels of risk or require skills that are not well developed (e.g. accurate scoping and estimating). Occasionally a strong-willed client will demand an alternative pricing structure.

In order to choose a pricing structure that maximises the value created between a firm and a client, both parties should be involved in exploring and choosing the approach. The problem is that pricing is often viewed purely as a means of splitting the value created between the client and the firm. This mindset can lead to treating pricing as an adversarial, win–lose, proposition. While the choice of 'price-level' is purely about splitting the value, the design of a sound 'pricing structure' can enhance the value created for both the firm and the client. This can be achieved by aligning objectives, appropriately allocating risk, providing certainty and ensuring a focus on maximising the value created.

There is no ideal structure, but, like most disciplines, having a solid understanding of the primary options, their strengths and weaknesses and when they are most applicable aids the development of better, more innovative approaches. Using the wrong pricing structure can destroy value and damage relationships. On the other hand, the right pricing structure can drive appropriate behaviours and quality outcomes.

For example, American technology giant Cisco has moved to a fixed-fee arrangement with a firm for all of its litigation, which has created an incentive for the law firm to focus on avoiding litigation. This example was cited at a conference in 2007 by Mark Chandler, Cisco General Counsel, who said the company was also paying fixed fees for patent disclosures and the prosecution of the applications, but reducing the fee by 5 per cent each year. This in turn was creating a strong motivation for the supplier firm to innovate in cost management.

CHOOSING THE RIGHT STRUCTURE

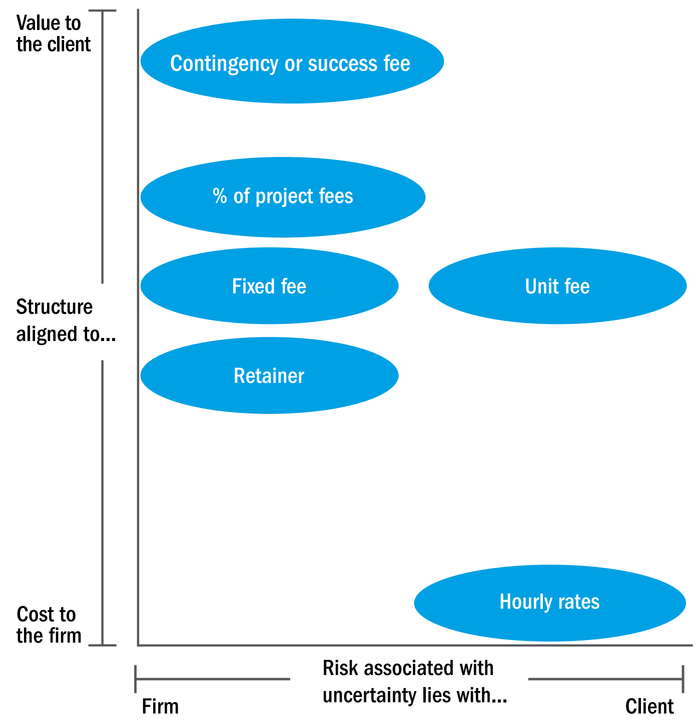
In selecting a pricing structure, discussion often turns to the question of who should carry the risk associated with uncertainty. Ultimately this decision comes down to who is best placed to estimate and manage the risk.

As with most situations, carrying the risk should result in a greater reward. A firm moving from hourly rates to a fixed fee is taking on more of the risk. In this situation most clients would be willing to pay a (slight) premium for the certainty this provides to them.

Figure 2 illustrates how different pricing structures align with either cost or value, and who carries the risk of uncertainty. Because a single fee structure rarely satisfies all the needs of the clients and the firm, trade-offs are often required and can be accommodated through hybrid fee structures such as:

- capped fees – hourly rates up to an agreed maximum
- retainer plus – retainer charged, often at a discounted rate, in return for guaranteed volume of work, reverting to an hourly rate in specific circumstances
- discounted fixed fee with a success bonus – e.g. 75 per cent of standard rates with an additional 50 per cent paid if successful.

Figure 2 – Alignment with value and the allocation of risk



Hybrid structures recognise that different components of a project come with different risks. An example of this may be standard fees for certain components such as certain interlocutory steps in a litigious legal matter, with hourly rates for time spent in court. Another example is a fixed contract with variations reverting to hourly rates.

It is through the knowledge of when to use alternative pricing structures in the specific context of a firm–client relationship that truly innovative and valuable hybrid structures can be developed. This should not be seen as the sole responsibility of the firm or the client but rather a combined exploration of what pricing structure is best for the overall relationship.

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KEY PRICING STRUCTURES TO CONSIDER AND THEIR PROS AND CONS

PRICING STRUCTURE	PROS	CONS	WHO BEARS THE FINANCIAL RISK	WHEN TO USE	HOW TO MANAGE
Hourly rates (e.g. $500 per hour for a partner of a law firm, $250 per hour for a 3rd year solicitor)	• Low scoping cost • Easy to calculate • Easy to measure work done • Easy to manage • Aligned to costs • Readily available benchmarks • Allows flexibility of both scope and resources during the course of a project	• Can reward inefficiencies • Not aligned to benefits • Discourages innovation • Fee not known until post-project • High administrative burden for both client and firm in assembling and checking invoices	Clients – who may react by refusing to pay unexpectedly high bills resulting in write-offs	In a trusting relationship where the task is difficult to scope in advance	• Set milestones to review costs either periodically (e.g. monthly) or by reference to a stage in the project • Maintain good communication during the course of the project so there are no surprises • Communicate value delivered at the same time as communicating the costs incurred
Fixed fee (e.g. $200,000 for a consulting engineering project)	• Provides certainty to both parties • Enables agreement in advance • Enables clients to directly compare prices • Enables firms to extract a premium based on alignment with value to the client • Enables clients to more fully understand what is involved in the project	• May encourage firms to cut corners if they have scoped badly • May incur a high scoping cost for firms	Firms – who may respond by tightly managing to scope, seeking regular variations, and seeking a premium in exchange for giving the client price certainty	When the project can be accurately scoped in advance and the firm has full control of the project	• Ensure accurate scoping of the project before fixing the fee • Analyse previous similar projects to assist with scoping and estimating • Fix in stages so that the fee can be reassessed at the completion of each stage • Discuss in advance where variations to the scope are likely to occur and clearly articulate how those variations will be managed
Percentage of value of client project (e.g. architect is paid 5% of the total project fee)	• Easy to calculate • Aligns to benefit • Readily available benchmarks	• May not be aligned to costs of the firm or the actual value of the service to the client • May be overly simplistic • Does not encourage firm and clients to seek ways to jointly reduce costs • Can result in conflicting objectives between keeping project costs down and maximising fees	Firms – who may deliver an acceptable, rather than high-quality, outcome	When the service is aligned to the value of the project	• Clearly articulate the value of the project and the fee in advance • Clearly articulate the services to be provided for the fee
Contingency or success fee (e.g. $500,000 for the investment bank if the acquisition proceeds)	• Low risk for client (i.e. pay nothing if not successful) or only pay more if a result is achieved • Aligns client's costs with client's revenue • Aligns firm to client's objectives • Firm should be able to extract a premium for sharing the risk	• High risk for firm (i.e. all or nothing) • Not aligned to costs • The firm's contribution may have limited impact on the client's success • Asymmetry of information between the client and the firm may make the arrangement unfair to one party	Firms – who should respond by seeking a price premium and being choosy regarding which projects to participate in	• When the firm's contribution is key to the client's success and where the firm can reasonably evaluate the chances of success • Ideally in a relationship involving multiple transactions to even out the risk	• Ensure an open and equitable relationship for long-term success • Consider adopting a hybrid structure with a base component and then an upside if the result is achieved
Retainer (e.g. PR agency paid $10,000 per month)	• Provides certainty to client and firm • Easy to manage • Readily comparable benchmarks • Encourages creativity in approach to achieving objectives	• Workload, or perception of workload, may vary from month to month • May create misalignment of objectives between client (wanting greater benefits) and firm (wanting to do less)	Firms – who may react by seeking to minimise effort	• When client needs a fixed budget • When requirements can be clearly articulated in advance	• Pilot in the early stages to produce a realistic estimate of requirements • Clearly articulate what is included and how variations will be managed
Unit fee (e.g. $2,500 per patent renewal)	• Easy to manage • Low scoping cost • Provides certainty to client and firm • Aligns to firm's costs • Readily comparable benchmarks • Encourages efficiency of process and innovation	• Most professional services are highly customised and few can be unitised	Firms – who may be forced to cut corners or leverage the work to such an extent that quality is compromised	When repeatable project work costs a similar amount	• Clearly articulate what is included in the unit fee and the level of professional who will do the work • Focus on process efficiency to extract maximum profit but avoid compromising the integrity of the offering

US LAWYERS AND CLIENTS TALK VALUE

The US Association of Corporate Counsel (ACC) has been hosting meetings throughout the US and worldwide involving in-house and law firm leaders with a focus on the emerging theme of value.

While there has generally been a reduction in non-law firm costs over the past 10 years, law firms' prices have jumped dramatically. Believing that solutions must come from true dialogue, the ACC Value Challenge is based on the concept that firms can improve the value and reduce their costs to corporate clients and yet maintain strong profitability.

For more information refer to acc.com.

IN DEFENCE OF THE BILLABLE HOUR

It is worth focusing on the billable hour since it has been a matter of controversy for many years, particularly in law. This is primarily because of concerns that hourly rates encourage and reward inefficiencies.

Despite endless discussion of alternatives, most firms and clients alike have been unwilling to abandon the billable hour. It is again under pressure as the economy has tightened, but to think that simply eradicating hourly rates would deliver greater value for clients confuses pricing structures with price levels (i.e. the amount charged per hour).

There is a role for hourly rates in the same way as there is a role for fixed fees, contingency fees and retainers. To blame hourly rates for the erosion of client value is the equivalent of a tradesman complaining that his saw won't drill a hole in the wall. Using hourly rates in inappropriate circumstances is not the fault of the pricing structure, it is user error.

Take the example of a client who has a dispute with a major supplier. The client has asked a law firm whom they trust to act as their advocate. Being a savvy buyer, they want to agree a price up-front, but neither the client, nor the law firm, is able to define the scope. The terms of the dispute are not yet clear. It is also not clear how hard the supplier will pursue the case or how willing they are to settle. In these circumstances the only sensible pricing structure to use is hourly rates.

The case progresses and all parties have agreed on the scope of the dispute, the process for its resolution and the timetable. Having experienced many similar disputes, the law firm is now better placed to provide a cost estimate. The firm could now agree a fixed fee for the remainder of the work. The firm and the client in fact continue the matter using hourly rates as the basis for charging.

This example highlights that hourly rates are often overused when alternative pricing structures are more appropriate (i.e. fixed fee). The lawyer and the client need to agree upon a structure that is most appropriate in the circumstances. Once the appropriate pricing structure has been agreed upon, clients and firms can focus on the issue of maximising total value and fairly sharing that value.

LEARNING FROM EACH OTHER

Returning to where we began, there is a time and place for different pricing options. With an understanding of the options available, professional service firms should reassess their pricing structures across the range of services that they provide and the projects they are involved in. They should also engage proactively in a dialogue with their clients with the intent of reaching a position of 'win–win' pricing rather than 'win–lose'.

Why not give the client a choice? Set each fee within the alternative structures at a level that makes the firm indifferent to which one the client selects. For example, a retainer could be discounted for a guaranteed flow of work and a fixed fee could include a premium to compensate for the risk of uncertainty of scope. Both of these models could be presented to the client with the option to choose between them. At a more general level, firms should at least undertake the following:

- Ensure a clear and accurate understanding of the cost of a unit of production through the allocation of costs. (Recommended reading on this topic is H. T. Johnson and R. S. Kaplan, *Relevance Lost: The Rise and Fall of Management Accounting*, Harvard Business Press, 1987.)
- Explore alternative pricing structures with clients and when and where they might be employed.
- Standardise the approach to pricing across services that are repetitive or easy to scope in advance by reviewing similar projects and scoping in detail a typical example of that type of project.
- Educate those in the firm involved in the pricing process to understand the rationale for using alternative fee structures.

Focusing on choosing the right pricing structure, rather than simply looking at price levels within an existing paradigm, will pave the way for more meaningful discussions about value and will build trust between the client and the service provider. In this context, the controversy about some pricing structures, such as the billable hour, should eventually disappear. ■

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