# Is Performance-Based Pricing the Right Price for You?

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## Executive Summary:

Not every industry or company can benefit from performance-based pricing. But where there is a fit, PBP can be a powerful tool that merges the interests of buyers and sellers, says Harvard Business School professor **Benson Shapiro**


Because pricing is such a difficult and complex arena, it has confounded sales and marketing executives and scholars for centuries. In no other marketing element is the two-sided conflict and cooperation nature of the buyer-seller relationship made so clear.

Part of the relationship is a zero-sum game between buyer and seller in which one's gain is the other's loss. Pricing is at the center of this part. But, there is a second, win-win part of most buyer-seller relationships, including almost all business-to-business relationships. The win-win part often includes improved products and services that simultaneously provide greater customer value and higher supplier profitability. We constantly strive to move elements of the relationship from the zero-sum conflict side to the win-win cooperation side to achieve business success and relieve personal angst on both sides. We have searched for ways to move pricing into the win-win category. In some situations, performance-based pricing can make pricing a win-win element of the buyer/seller relationship.

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Performance-based pricing is an arrangement in which the seller is paid based on the actual performance of its product or service. It is becoming much more popular. In the advertising industry, agencies had been traditionally paid 15% of the cost of the media they bought for a client. Now, more and more agency/client relationships are moving to performance-based pricing—they are paid based on achieving certain client advertising and/or marketing goals. The contractor who rebuilt the 1995 earthquake-damaged freeway in Los Angeles received enormous

performance incentives by completing the reconstruction early. Other industries as diverse as consulting, trucking, and heavy industrial services are seeing the same trend.

Before explaining the benefits, drawbacks, and application of performance-based pricing, let us describe an example involving a complex relationship between ABB and Ford. 3 Ford needed a world class supplier to design and build a turnkey automotive painting facility in Oakville, Canada. Ford and ABB agreed to work together in an initial preparatory phase, rejecting the traditional approach of bids based on incomplete information.

The initial preparatory phase involved a significant exchange of information and perspectives between the two firms, and led to a novel type of agreement. ABB would design and build the plant at a far lower cost than standard. Then, if ABB could reduce the cost even further, it would receive a pre-agreed percentage of the savings. This innovative, performance-based approach left both parties significantly better off than under conventional bidding or a negotiated price arrangement. Ford received a significantly lower cost at a lower level of risk: ABB received a share in the cost and design improvements it was able to create.

## Performance-based advantages

One advantage of performance-based pricing is the often-mentioned alignment that can be achieved between the buyer's goals and the seller's goals. But, that is only part of the story. There are two other major advantages.

Performance-based pricing is insurance. It insures that the seller does not undercharge the buyer. When the final performance of the service or product is in doubt, the performance-based arrangement guarantees that as the seller provides more, it is paid more. Significantly, the buyer also receives insurance that it will not overpay at both the institutional and the individual level. No person or organization wants to pay more for a product or service than it is worth. Again, when performance delivery is in doubt, performance-based pricing enables the buyer to pay only for the amount of performance that is actually delivered on a measurable basis. Most importantly, the individuals responsible for the actual purchase decision do not want to absorb the career risk of overpaying. In our personal lives, if we overpay for a product, we suffer some marginal consequence. In business, it can literally end the job security of a procurement executive. For its insurance role, performance-based pricing creates a greater sense of "fairness" for both buyer and seller.

The third benefit may be even more important than the first two. We often see performance-based pricing in highly uncertain situations, and where both buyer and seller must make complex trade-offs among conflicting objectives.

Simple contractual arrangements do not force the buyer and seller to communicate in depth to one another. Performance-based pricing arrangements are generally very intricate. The parties are forced to deal with one another's limitations, objectives, and trade-offs. The very process of discussing, in precise detail and with great discipline, these issues develops "wide-band width" communication between buyer and seller. Each has the opportunity to precisely present its objectives, and to explain its own issues.

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This process of open communication encourages a great degree of buyer/seller cooperation and coordination, and literally a much broader agreement. More issues are raised and factored into the high sensitivity problem-solving process. When the two parties involved are buying and selling committees representing different organizational jurisdictions *within* their organizations, and perhaps different levels of management, the necessity for precision and discipline in communication helps the process within buyer and seller groups as well as between them. It, in fact, leads to better agreements that provide more value to the buyer and lower cost to the seller. Customers only receive and pay for what they value and suppliers can reduce costs by removing non-value-added service and product components. The win-win aspect of the relationship increases and the zero-sum aspect decreases.

## Powerful logic, proven in practice

Performance-based pricing is growing because 1) its economic logic is so powerful; 2) it provides new opportunities for buyer/seller communication; and 3) it has been proven in practice. After successful deployment by credible players (e.g., EDS in systems integration and outsourcing, services such as waste cleanup and welfare recipient job placement for government agencies, and many advertisers and advertising agencies), it is clear that the approach is implementable. Even Procter and Gamble, the last major consumer packaged goods advertiser to stay with a 15% fee, is moving in this new direction. It is sometimes a pragmatic pathway to managing risk, uncertainty, and performance for the long-term benefit of both parties.

Advertising has been a fertile field for performance-based pricing. The September 14, 1998 issue of *Advertising Age* reports that the percentage of marketers who compensate agencies on billings (media purchases) dropped from 71% in 1983 to 35% in 1997. Furthermore, the average profit margins of large agencies, according to a study by Morgan Anderson Consulting, went from 13% to about 19%. This demonstrates how profitable performance-based

pricing can be. The trend toward broader agency involvement with clients beyond traditional advertising has made it both possible and appropriate for the move to a new pricing approach—one that provides the agency with more opportunity in return for greater risk and broader, more integrated responsibility.

## Not always the best solution

But, performance-based pricing is not for all pricing situations. In fact, it is appropriate in only a limited number of situations, albeit some very important ones. But, some limited variants can also be useful. "Point" guarantees such as penalty clauses which involve a discount when delivery is late are a simple form of performance-based pricing. Penalty clauses are becoming typical in major construction projects.

Performance-based pricing is complicated. As with usage-based pricing and point guarantees, the actual amount to be paid can’t be determined until after delivery, and often even after usage, of the product or service. Thus, for example, time of day pricing (e.g., restaurant "early bird" specials or cheaper cinema matinee pricing) does not fit into the performance-based pricing model. Neither does stratified service pricing such as first class and economy in air travel. This is similar to product line pricing, and can be considered service line pricing.

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Performance-based pricing differs from usage-based pricing in that it charges for the quality of performance as well as the quantity of usage. If the telephone company charged a performance premium for better sound quality or faster connections as measured in use, these would become performance-based prices. Both performance-based and usage-based pricing, however, set price after service/product delivery when the customer value is clear. These are both wonderful examples of using the pricing approach to clarify value for the customer and expand the spread between customer value and cost.

It is useful to consider the risk embodied in various pricing approaches. Pricing that is openly based on costs plus a predetermined profit margin, and is often referred to as "time and materials," involves no vendor cost risk or price risk. The customer pays for all cost overruns and the supplier's profit is established before delivery. Typical fixed-price sales involve only cost risk for the seller. The price is set before the product or service is made or provided. Performance-based pricing moves both the cost and price risk to the seller. Neither is established before the deal is made. But the vendor then obtains the opportunity to better manage the spreads among value to the customer,

price, and cost to its advantage. With risk comes added opportunity. The vendor who uses performance-based pricing must thus be willing to accept greater, two-sided (price and cost) risk for added reward opportunity.

Finally, performance-based pricing is not good for sellers who desperately need short-term cash flow. Because the price can only be determined after delivery, and often not until after usage of the product and/or service, payment is often delayed more than normal. A software startup, for example, might desire to price on the basis of the value-in-use of its software, such as cost savings to the customer. Such an approach might make the sale easier because of the alignment, insurance, and high quality communication benefits of performance-based pricing. The problem is that the savings from the software utilization might take months to determine, thus delaying payment to the software vendor. Most startups can't wait for cash flow.

A possible solution in some cases would be progress payments including early fixed payments and later performance-based payments. The trade-offs here, including revenue recognition, are quite complex and might force the vendor away from performance-based pricing.

## Application guidelines

The complexity and custom nature of the performance agreement mean that performance-based pricing is only applicable to relatively large, important transactions/relationships for both the buyer and seller. The up-front cost of exchanging information and negotiating the performance goals and measures as well as the cost of applying the measures mean that this isn't for small or trivial situations. The power of the approach really comes to bear only when there is a mutual need to focus on joint objectives, and the abilities to meet those objectives are fraught with significant uncertainties. Performance-based pricing must be implemented with care and vigor. It is not a half-way solution.

Experience provides pragmatic guidelines for implementing performance-based pricing:

1. Invest the time up-front to carefully and fully define the objectives of the project and exchange all the relevant information. Both buyer and seller must understand their own and the other party's situation, including overarching business goals and strategy. If there are serious functional and/or other internal fractures on either side, the process won't work.
2. Broaden the negotiation perspective to encompass all elements of the situation. That way each party can bring to bear its most complete arsenal of tools and approaches.

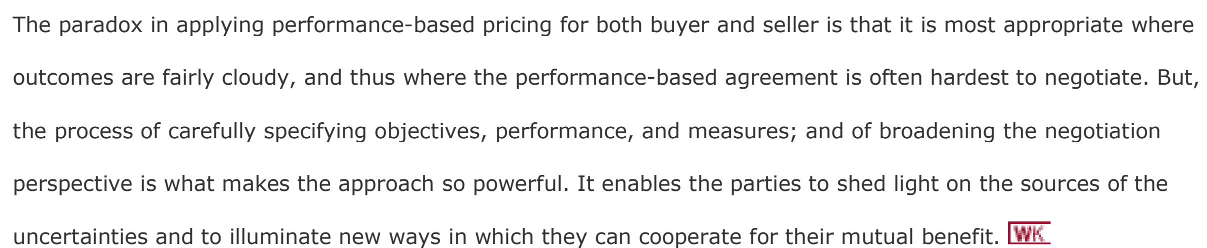
3. Explore a wide range of outcomes and consider what is controllable by the seller, the buyer, and neither. The exploration of outcome and the broadening of the negotiation perspective (number 2 above) require substantial creativity.

4. Take the time to negotiate completely. Do not rush because important details can and will be lost in haste.

5. Develop clear measures of achievement for each objective. Specify precisely what "performance" means.

6. Enumerate an explicit formula to relate payment price to performance outcomes.

7. Specify a mechanism to adjudicate disagreements over outcome measurement.



The paradox in applying performance-based pricing for both buyer and seller is that it is most appropriate where outcomes are fairly cloudy, and thus where the performance-based agreement is often hardest to negotiate. But, the process of carefully specifying objectives, performance, and measures; and of broadening the negotiation perspective is what makes the approach so powerful. It enables the parties to shed light on the sources of the uncertainties and to illuminate new ways in which they can cooperate for their mutual benefit. WK