



CFV Fee Pricing

ian@ianheptinstall.com

CFV is short for **C**ost + **F**ixed + **V**ariable. It is an approach to pricing complex contracts where the scope of work can vary significantly during execution.

CFV is typically used for:

- Major CapEx and construction contracts, especially relating to collaborative contracting, IDP teams and project partnering.
- Complex service contracts, such as maintenance or IT services.
- Large purchases where technology changes rapidly, or there is a very wide range of alternative solutions to the same problem, and the choice is not simple.

CFV removes many of the incentives for suppliers to behave in ways that are not in the interest of the client that can arise on complex contracts when using *fixed-price* and "*cost-plus-a-percentage*" pricing.

Objectives & Benefits:

The purpose of using CFV pricing is to align the commercial interests of supplier and buyer, and also different suppliers working on a project. It reduces commercial barriers to collaborative working across the team involved in the contract.

This alignment can bring the following benefits

- Suppliers act pro-actively to make improvements to time, cost and quality.
- Less conflict amongst project team members from different companies.
- Risk and opportunities are uncovered early rather than hidden
- Less need for the buyer to "police" the contract.
- Lower costs, because suppliers are not expected to cover risks they can not easily influence.
- It supports the implementation of a range of value-adding methods across the project (eg Critical Chain Project Management, Value Analysis/Engineering, Risk & Opportunity Management, Information & Knowledge Management).

Process

The CFV method splits the supplier's payment into three parts:

1. **Cost**

The supplier is reimbursed for the money they have to spend working on the project. The idea of "cost" is that 100% of the money flows straight through the supplier. Typically this includes purchased goods and services and the employment cost of staff working on the project. Cost does not include any allowance for "overheads", or any mark-up whatsoever. This is covered in the next element.

Cost would typically be paid monthly.

2. **Fixed Fee**

This represents a contribution to the supplier's fixed costs. It would typically be paid monthly, or on receipt of defined deliverables.

3. **Variable**

This fee is linked to performance. Where the supplier's contribution is relatively self-contained, this would be their own performance against criteria agreed with the client.

For the larger suppliers on a major project, this fee would usually be linked to the performance of the overall project, rather than the supplier's own individual contribution. On projects where there are more than one supplier on CFV pricing, the variable fee can be used to align the commercial interests of different suppliers with those of the client, as shown in the worked example below.

The performance criteria should relate to value in the eyes of the client, but also be related to things that the supplier can influence. The variable fee would usually be paid on completion.

The variable fee is often referred to as "profit at risk", where the nominal value equates to the expected profit on the contract. The variable fee doesn't always have to be equal to the expected profit (see notes later).

Example – CFV used on a Project

A project to upgrade a chemical plant in the UK had selected two suppliers to form a "project alliance", or Integrated Project Delivery (IPD) Team. The two supply partners agreed to work collaboratively on the project, with aligned risk and reward, using CFV.

The project had a total value of \$20M. This value was nominally allocated between the two partners, based on their areas of expertise. In this example it is 50:50. This was then further divided into the CFV elements for each supplier:

	Supplier A	Supplier B
Cost	\$7.5M	\$8.5M
Fixed	\$2.0M	\$0.7M
Variable	\$0.5M	\$0.8M
Total	\$10.0M	\$10.0M

The allocations in this case were based on the business averages in the published accounts of the suppliers. A had a higher fixed cost base (25% GM) and B's was lower (15% GM). The variable fee was based on the net profit (PBIT/EBIT), and the fixed fee on the operating expenses. An alternative approach is to make the total fee and the split between fixed and variable, part of a competitive selection process, with bidders proposing fixed and nominal variable ("at risk") fees.

The client had already established a robust estimate and project plan, and the selection process did not require bidders to compete based on the total project cost - it was a pre-defined target that the bidders had to be comfortable working with. This they did during the post-selection contract finalisation period.

The variable fee was linked to 5 project performance measures. The variable fee paid would vary from 0 to 2x the nominal value in the table above. An excellent project would thus allow both suppliers to double the profit they made (since in this case the nominal variable fee was equivalent to their net profit made on a job of this size). The 5 performance measures are shown in the table below, along with the nominal values of the variable fee.

	Allocation %	Total Partner Risk	A	B
Safety	30%	390,000	150,000	240,000
Shutdown Duration	25%	325,000	125,000	200,000
Cost	20%	260,000	100,000	160,000
Schedule	15%	195,000	75,000	120,000
Quality	10%	130,000	50,000	80,000
	100%	1,300,000	500,000	800,000

During the final negotiations to define the formal contract, the three parties defined the measures for each of the five measures. The cost performance fee (sharing of cost savings) was uncapped, provided all of the other measures achieved acceptable performance.

In practice the use of CFV payments on this project facilitated great collaborative behaviours. The only way both A and B could make more money was to ensure the project was a success. There was no mechanism whereby A could make more money

whilst B didn't. It didn't matter who placed orders for materials, who employed a project team member, or whose supplier or subcontractor caused a problem.

The result? The client had never had a project on their site that completed to time or to budget before this project. This one was on time and slightly under budget. The new process started on time, and business was not interrupted. The suppliers achieved a variable fee 1.36 times the nominal value. They both say that that had the project been contracted and managed in a traditional manner, it would have almost certainly have gone way over budget and programme.

Notes & Recommendations when using CFV Fees

- ❖ **CFV Fee pricing is not a silver bullet.** It is a way to remove barriers to buyer-supplier and project team collaboration. Whilst it will bring benefits from its use in isolation, the real payback comes where the collaborative environment is exploited to implement improved ways of working.
- ❖ **The cost element has to be pure cost.** If the cost includes allocation of overhead in the organisation, it could be more rewarding for the supplier to increase the cost, rather than try and achieve the variable fee. The test is "will this money go directly into the pockets of suppliers or employees?". Whilst it may make sense to simplify the cost calculation process, you should ensure that the variable fee is the most powerful reward.
- ❖ All off-invoice **retrospective discounts and rebates** that the supplier may have negotiated with suppliers must be disclosed before entering into the agreement, and ideally the cost fee will be nett of any such rebates. An undisclosed financial interest in a supplier is in conflict with the idea of an open collaborative team.
- ❖ On projects, and for the supply of services, you should **define the staff who are included in the cost payment**, and which are included in the fixed fee. staff working full-time on the contract are almost always included in "cost" - based on their actual salary plus direct employment expenses (such as car, medical, pension). This means that each staff member may have a different reimbursement rate. You can use average rates for role types to simplify the process, though care is needed to avoid it becoming a way to improve profit. The part-time involvement of management and supervision will usually be covered in the fixed fee. For roles that could be either this should be clarified during the selection process, or specified in the RFP/tender document.
- ❖ Only pay **overtime** as part of the cost fee if the individual is actually paid overtime"
- ❖ **Supplier selection on a CFV contract is usually based on competence and capability** more than a detailed price quotation. The relevant price are the fixed and variable fees. This ensures a focus on the distinctive differences between bidders, rather than the money they spend with their suppliers. A main contractor on a construction project will spend 70-90% of the bid price, but the expertise you

are buying represents only 10-30% of the bid price. If cost is included it is recommended that it is an overall cost indication/estimate that the supplier is willing to link the variable fee to, rather than a traditional fixed-price quotation.

- ❖ The **variable fee is often based on the expected profit** the supplier would make on the contract – “profit at risk”. This is quite a reasonable practice, and is seen to balance the risks to the client – sufficient financial pain/gain to encourage the right behaviours, without the supplier's pain being too damaging to inhibit innovation and openness. Some suppliers prefer to agree a higher variable fee with a lower fixed fee.
- ❖ On multi-year service agreements, you should agree to **reset target performance levels regularly**, so that one period's “excellent” performance becomes the next period's “standard”.