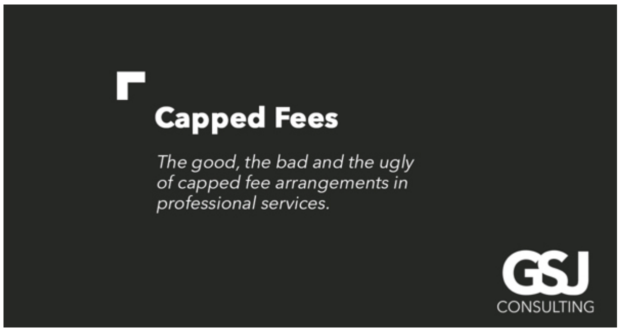

Capped fees – the good, the bad and the ugly

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When a client first asks you for a capped fee, you'll likely not think too much about it. After all, what can go wrong? All you need to do is to scope the work, workout the leverage, think about how long it will take you to do the task and then add in a little buffer. Hey, presto, you have your capped fee!

And while I think most professionals do think along those lines, it is my belief that this type of thinking is a mistake. I hope this article sets out why you shouldn't be doing capped fees at all.

What are capped fees?

Before we start, let's set out what a 'capped fee arrangement' is.

Capped fees refer to an arrangement where a service provider (professional) agrees to perform work for a client with the understanding that the fees will not exceed a specified maximum amount, regardless of the actual time or resources required to complete the job.

Unlike open ended hourly billing, where clients pay for each hour worked, capped fees are hourly billing arrangements that provide a financial ceiling – allowing the client to know the maximum possible cost of the job upfront.

The issue of risk

As professionals you are trained to identify risk. We could go further. You are trained to de-risk – to take any risk there may be out of the equation. Not only that, but as professionals you are also trained negotiators.

But by agreeing to a capped fee arrangement, you agree to take on 100% of the pricing risk.

I have no issues with that. A professional agreeing to take on 100% of the pricing risk upfront is not the problem. What is the problem is that you don't get to charge a premium for taking on this risk. Why? Because by agreeing to cap your fee you are agreeing to put a ceiling on your fee. The fee itself is standard hourly rates.

And what is wrong with this? By agreeing to take on the pricing risk upfront, the professional should be rewarded a premium for accepting that risk. After all, that's what insurance companies do!

What do we mean when we say you are agreeing to take on 100% of the pricing risk?

Here is the equation:

If your fee is less than the agreed capped fee, that's all you'll get. If your fee exceeds the cap fee, all you'll get is the agreed maximum fee.

Remember, a cap fee is not a fixed fee.

So, the only way you can "win" by agreeing to cap your fee is if you hit the actual cap!

The issue of leverage

Agreeing to cap your fees means you agree to your leverage model upfront. That's not necessarily a bad thing until you start to get near your cap. Then it is no longer in your best interests to use the modelled leveraging, but rather to use the cheapest labour you can find!

On the flip side, if you are getting close to the end of the matter and are nowhere near your agreed cap, then you may be incentivised to stack your file in order to pad out the bill.

As a result, agreeing to a cap fee doesn't automatically allow you to put the best people/resources on the job, but the ones who will get the job done within the cap – which in some instances might be a bunch of paralegals!

Frankly, this type of arrangement isn't in the best interests of you or your client.

The issue of scope creep

There is a general presumption on the part of professional service providers that if scope creep enters a transaction with a cap fee arrangement, then the capped fee arrangement is no longer applicable.

Wrong.

In the minds of clients, a capped fee is a fixed fee to the extent that it places a ceiling on the amount you can charge. That does not automatically change just because there has been a change in scope – particularly if the client isn't aware there has been a change in scope.

Of course, you may have a reasonable client who agrees with you that the scope has changed during the course of the transaction and therefore the capped fee amount should be amended. But given any amendment to the fees will always be an increase in the capped fee, this isn't an easy conversation to have and most professionals shy away from having it.

This is particularly so when the scope creep happens at the junior level – when a junior member of the client team asks a junior member of your team to do a task outside of the original scope. In that scenario, the senior/leader on the client team will reasonably say they didn't authorise the request. And you've guessed it, the conversation gets kind of messy!

A better way - fixed fees

The next time your client asks you for a capped fee arrangement, reposition the conversation to be a conversation about a fixed fee arrangement. Not because a fixed fee arrangement is better for you the professional, but because it is better for both you and your client.

That's because, while an agreed fixed fee arrangement provides your client with the price certainty they want from a capped fee, it also provides you, the service provider, with the opportunity to reap a reward for taking on the additional risk in providing that price certainty.

Importantly though, it leaves a clear and open channel of communication around scope creep, and it will make having this conversation with your client so much easier.

As always, get in touch if we can help with any of this.

Further reading

- Dynamic pricing strategies for professional services
- 10 ways to build trust with your customers
- 5 reasons you need to unlock the secrets in your data
