

Cost-plus and haggle-minus

by

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Recently, the building of a fifth terminal at London's Heathrow airport – called T5 – has received some attention (*The Economist*, 13th August, 2004). The reason is that the project management has not been outsourced but is being run by the British Airports Authority (BAA). It may seem strange that self-management is a novelty but these are the times we live in.

What caught my attention, however, is that work being done by contractors is not a series of deals whereby each contractor is held to a fixed price for their work. Instead, the BAA is carrying the price risk with contracts that appear to be more of a cost-plus nature.

This is a surprise because, as a general matter, fixed price contracts provide high incentives for contractors to keep costs down. The reason is simple: any reduction in costs is kept by the contractor and not passed through. For the buyer, the benefit comes when contracts bid for these contracts. They anticipate cost savings they might achieve and this is built into their price at the bidding stage.

Cost-plus contracts provide no such incentives. If a contractor can't economise, it is the buyer that pays as those costs are passed through. Not surprisingly, absent other considerations, cost-plus may mean cost blow out.

But there are other considerations. It is a rare fixed price contract that can be written in an airtight manner with all key factors specified. What this means is that new circumstances arise, changes in design need to be made, and the lawyers come in. All this means a lot of haggling and renegotiation. And don't think potential suppliers are unaware of the extra revenue this can give.

So the BAA solution is to avoid this. Their manager, Tony Douglas, knew the design could not be made complete and, moreover, that the project would involve many contractors working on related tasks. Thus, by moving to a cost-plus situation, Douglas can pay for changes when they are needed and in the process avoid a costly blame game between the providers.

To be sure, there is a trade-off. Cost-plus and you have no haggle fuss. Fixed price and you can keep budgets nice. But as Stanford economists Pat Bajari and Steven Tadelis have argued, it is the sheer complexity of the project design that will determine the best path. For easy designs, pre-specification is possible and is a means of avoiding the haggle. For complex projects, pre-specification is prohibitively costly and possible fruitless. You can't avoid the haggle so you are better off making that part easier. That is, you procure extra tasks on the spot rather than trying to anticipate them early on.

T5 is not yet complete and so the jury is still out on whether the cost-plus/haggle-minus approach is best. Nonetheless, their experience will be a good reminder that high incentives can sometimes entail a high price. There is no automatic pilot in outsourcing and perhaps no substitute for on-going managerial attention.

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