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**POTENTIAL BENEFITS AND RISKS ASSOCIATED WITH  
BUNDLED SERVICE CONTRACTS**

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In this chapter, we describe a variety of potential benefits and risks associated with bundled service contracts, based on our interviews with buyers and providers of bundled facility management and logistics services as well as our literature review. All of these benefits and risks will not be applicable in every case. They may be more or less important given the types of services purchased, the other dimensions of the selected acquisition strategy, and the goals of the buyer that the acquisition strategy supports.

**COST SAVINGS**

The most common source of savings associated with bundled service contracts is the use of fewer personnel, made possible by many different factors:

- Buyers that bundle related services are able to reduce the number of personnel needed to provide those services through the use of multi-skilled, or cross-trained, technicians who can perform other jobs when their primary specialties are not needed. For example, a buyer with a separate contract for electrical repair services may require an electrician for only 30 hours a week, yet must pay for a full-time staff member. If those electrical services are included in a bundled contract with nonspecialty services such as painting, that electrician can be cross-trained to perform other types of activities when his/her specialty is not needed,

reducing the total staff required to provide the entire group of services.

- When buyers bundle multiple services at a site rather than contract for them separately, the provider can perform those services using fewer personnel because it needs a smaller pool of “filler,” or backup, staff during work breaks, vacations, or sick days. If a buyer contracts for receptionists separately, the provider must employ enough people to fill each receptionist position full time, everyday. However, when a provider controls receptionist services in addition to other services such as the facilities call center, the provider can maintain a much smaller pool of staff to fill vacancies across all of the included services when employees are away from their jobs.
- A provider can manage a group of related services within a bundled contract with a smaller total management staff than would be needed for separate management of those services through many small contracts. For example, the person who manages building maintenance activities, such as plumbing services, can also manage other services, such as janitorial.
- When a provider controls all of the services related to a single activity, it may have opportunities to reduce the total staff required for the activity by introducing process improvements, particularly those that reduce internal/external transaction costs. Such improvements may be facilitated by management information systems or alignment of the management of related services.<sup>1</sup> For example, one buyer of third-party logistics services initially purchased portions of inbound logistics services (from an overseas supplier to the buyer’s manufacturing site) from separate providers. One provider loaded the parts at the U.S. port, brought them from the port to a warehouse, and unloaded them there; another provider managed the warehouse; and a third provider loaded the parts from that warehouse and took them to the buyer’s manufacturing site. By consolidating the inbound logistics services and using an integrated tracking system, a sin-

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<sup>1</sup>Monczka et al. (1993) note that volume purchases of commodities (with longer-term agreements) can lead to opportunities for investments that improve productivity.

gle provider was able to bring the parts from the port to the manufacturing site with fewer labor hours.<sup>2</sup>

- When a buyer regionalizes provision of similar or identical services that were performed across many locations, the provider can often perform the regionalized services with fewer people because of personnel efficiencies. An example of this might be consolidation of facilities call centers.<sup>3</sup> Some efficiencies may be related to a smaller requirement for filler staff, as discussed above. Also, individual employees may be more productive through increased opportunities to share better ways of accomplishing services.
- As buyers shift to larger, more comprehensive contracts, providers can reduce the personnel in contract management, accounts receivable, and other activities associated with transacting with buyers (which are generally included in overhead costs paid by buyers).
- Similarly, buyers can reduce the personnel that set up and manage contracts and pay invoices.<sup>4</sup> For example, one buyer consolidated its 2500 pest control contracts to a bundled contract with a single provider, dramatically reducing the number of invoices that had to be processed each month.<sup>5</sup>

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<sup>2</sup>The provider also helped reduce needed pipeline inventory by almost 40 percent through quicker, more reliable delivery. See Boyson et al. (1999) and Ernst & Young and the University of Tennessee (1999) for discussions of costs associated with supply chain activities when activities are bundled versus separated.

<sup>3</sup>Another example relevant to the Air Force is consolidation of repair services for certain types of aircraft components.

<sup>4</sup>One provider told us that savings associated with the reduced need for buyer contract management personnel can be as great or greater than other types of savings associated with bundling. With the help of a good performance management plan [see Baldwin et al. (1999)], several buyers indicated that they manage very large bundled service contracts with only one to three in-house personnel. See, for example, Sadrian and Yoon (1992) and Monczka et al. (1993). Lawless (1991) also notes that an advantage of purchasing multiple related commodities through bundled contracts with a known supplier is the avoidance of time spent searching for other reliable suppliers.

<sup>5</sup>See Appendix B. Chrysler reduced its number of buyers by 30 percent by reducing the number of overall suppliers and eliminating the competitive bidding system (Dyer, 1996).

The use of fewer personnel is not the only potential source of savings. Additional sources are described below.

- Bundled contracts that include the responsibility for purchasing service inputs [materials or other services needed to provide the services in the bundle, e.g., cleaning supplies or HVAC (heating, ventilation, air conditioning) filters for facility management services or transportation for third-party logistics services] may lead to better purchasing power for the provider.<sup>6</sup> This in turn can lower total costs for the buyer.
- Buyers that choose to use a bundled service contract can use their increased leverage or market power with the provider associated with the larger workload to negotiate a lower profit margin for the provider.<sup>7</sup> As noted in Table 4.1, one buyer experienced significant savings in the fee it pays its provider by leveraging an expansion in the bundle of services purchased.
- Buyers may benefit through more efficient use of capital equipment if the services included in bundled contracts can share equipment (e.g., similar services provided at several locations that are fairly close to one another). A provider told us that one of its buyers used to contract separately for individual construction projects. One day, two cranes arrived to perform two jobs the same day. If those construction projects had been bundled into a single contract with one provider, the provider could have used one crane that day to accomplish both tasks. Similarly, for logistics transportation services, consolidation of inbound shipments allows more efficient use of trucks, leading to lower transportation rates.<sup>8</sup>
- Similarly, by regionalizing or consolidating services that were provided at many different locations (e.g., through consolidation

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<sup>6</sup>See Franklin (1998) for a discussion of how real estate and property management service providers are leveraging their purchases of goods and services to create savings that can be passed through to their buyers.

<sup>7</sup>We inferred from our discussions with providers that the total profit can be more important than the profit margin for the bundle. Sadrian and Yoon (1992) discuss increased buyer leverage resulting from higher-volume purchases of manufactured commodities.

<sup>8</sup>See Flynn (1993).

of repair services, warehouses, or distribution centers), buyers can save money through more efficient use of facilities.

- Buyers can avoid paying some duplicate overhead expenses by shifting from many small contracts with multiple providers to a single contract with one provider. Examples of such overhead expenses include workers' compensation insurance policies, pager and cellular phone rental charges for technicians (rates are better for larger quantities), company letterhead, and business cards (there are fixed set-up costs associated with the company name).
- When buyers use multiple providers for separate or small groups or services, they are paying to use many different management information systems (MIS) to track financial and performance data. To the extent these systems need to interact to provide information to the buyer, the buyer also pays for integrating systems and reconciling information. This is especially true for financial data that need to be tracked in a consistent format across all purchased services. These information-related expenses can be reduced and in some cases eliminated by shifting to a bundled contract with a single provider with a good MIS capability.

## PERFORMANCE IMPROVEMENTS

Providers of bundled services can increase performance for their buyers (i.e., improve quality, responsiveness, flexibility) in a variety of ways.

- Alignment of all services related to a specific activity through a bundled contract can lead to improved provider accountability and coordination of these services, which in turn can lead to increased provider responsiveness and flexibility.<sup>9</sup> For example, when a toilet overflows, (1) the janitorial staff is needed to clean up the water, (2) plumbers are needed to fix the underlying problem, and (3) building maintenance and/or groundskeeping staff potentially are needed to help the plumbers access hidden or buried pipes. If these services are provided through separate

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<sup>9</sup>Lawless (1991) notes that this is also relevant to commodity bundles that include integrated products.

contracts, the buyer must coordinate all efforts or run the risk of a bad outcome. Mishandling of the problem can lead to finger-pointing on the part of the different providers and potentially more costly repair work, such as unnecessary damage to landscaping while accessing buried pipes. However, if these services are included in a single contract, the provider is responsible for bringing together all necessary resources to fix the problem and for coordinating the efforts to minimize expenditures and disruptions for the buyer.<sup>10</sup> Similarly, when a buyer shifts from using multiple carriers and freight forwarders for shipments to an integrated carrier (like FedEx or the United Parcel Service), the integrated carrier is responsible for the entire shipping process. Thus, the buyer has one number, rather than several, to call if a shipment is late or damaged en route.<sup>11</sup>

- Alignment of related services for a single activity through a bundled contract also allows for better performance-measurement opportunities (e.g., through integrated MIS and better data integrity).<sup>12</sup> These integrated data in turn can help the provider improve the processes underlying the activity and thus improve performance for the buyer. For example, leading providers of integrated facility management services use call centers to capture comprehensive information about facilities problems and the activities needed to fix these problems and perform preventive maintenance (e.g., frequency, time, materials cost).<sup>13</sup> For consolidated third-party transportation services, the state-of-the-art data systems are beginning to allow an integrated provider to track material in transit so that (1) it can be quickly rerouted if necessary to avoid problems and (2) plans can be made by the buyer to quickly use the material (i.e., the buyer can time repair or manufacturing activities based on the arrival of the material).

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<sup>10</sup>See Alchian and Demsetz (1972) for a discussion of the team production problem. Unfortunately, the benefits associated with addressing such problems through bundling could be difficult to quantify or predict with any precision ex ante.

<sup>11</sup>See the discussion of multi-node versus direct-distribution pipelines in Ernst & Young and the University of Tennessee (1999).

<sup>12</sup>This also gives the buyer greater confidence in the provider's performance.

<sup>13</sup>See Baldwin et al. (1999) for a discussion of call centers.

- Buyers can use the fact that bundled contracts allow providers increased control over performance outputs to convince providers to tie more of their fees to levels of performance. Generally, the more control a provider has over processes associated with an activity, the more willing it will be to put a larger portion of its fee at risk based on the performance output for that activity. Tying fee to performance is a strong incentive for the provider to meet buyer needs. As an example, one facility management provider told us that if it does not control the main services that affect customer satisfaction, including such services as janitorial and grounds maintenance, it is much less willing to tie a significant portion of its fee to customer satisfaction ratings.<sup>14</sup>
- Similarly, buyers and providers are better able to align the performance of services with the overarching goals of the buyer organization through the use of bundled contracts, rather than many separate contracts covering subparts of single activities. If the goal of a buyer is to increase employee participation in on-site food services, it may be easier to align the incentives of a single provider that is responsible for maintaining the food service facilities and grounds and preparing and serving the food than to align the incentives of several providers each in charge of one of the individual pieces.
- Buyers that purchase similar or identical services for many sites through separate contracts with many different providers often find it difficult and costly from their perspectives to achieve consistent service levels across sites.<sup>15</sup> However, by shifting to one or a few bundled service contracts, buyers can leverage provider capabilities and existing data systems to achieve consistency of service levels across the whole workload, guaranteeing service-level standards are met and unreasonable service requests are reduced. One of the buyers we interviewed has offices in many locations. Originally, the buyer had separate landscaping con-

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<sup>14</sup>As the Air Force experiments with using performance incentives for its aircraft heavy maintenance services, providers may be less willing to tie their compensation to performance measures such as on-time delivery if they do not control important pieces of the process such as supply of spare parts and subcomponents.

<sup>15</sup>The buyer has to invest in personnel and data systems to track and manage service levels across separate contracts. In practice, such funds are rarely forthcoming for noncore activities such as facility management services.

tracts for individual sites. Because office managers at the different locations had very different expectations about required landscaping services—ranging from what headquarters viewed as unreasonably high to unacceptably low (conveying an inappropriate image)—grounds appearance varied significantly from location to location. After bundling its facility management services across these locations, the buyer created landscaping appearance standards and turned over management and enforcement of these standards to the provider.

- Buyers that purchase multiple services at a single site through a bundled service contract (rather than many small contracts with separate providers) benefit from the greater flexibility of the provider to quickly shift resources among services to meet emerging or emergency buyer needs. One buyer told us that during the threat of a flood, its provider called in all staff to fill sandbags to place around the buyer’s facilities. Without a single bundled contract, buyer personnel would have had to coordinate this effort across personnel employed by many different providers.<sup>16</sup>
- Bundled service contracts give buyers greater leverage with their providers to negotiate customized services or possibly higher performance levels without incurring the usual costs. For example, buyers may be able to request tailored performance reports (or even a slight scope or scale expansion) at no additional cost. One buyer bundled all of its elevator maintenance into one contract and negotiated an on-site maintenance person for each location with 50 or more elevators at no additional cost.
- Bundled service contracts can lead to a reduction in personnel turmoil, leading to improved performance for the buyer. When a buyer purchases services through multiple small contracts, a subset of those are always being competed, leading to potential incremental on-site provider personnel transitions.
- Bundled service contracts can lead to reduced personnel turnover through expanded career opportunities, which can lead

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<sup>16</sup>In addition, large providers (that may be interested only in larger, bundled service contracts) often have the capability to pull resources from other sites (i.e., surge) to help a buyer during a crisis.



to higher performance for the buyer. When a provider controls many diverse, but related, services, employees have opportunities to cross-train and move from one service area to another (e.g., from central heating plant maintenance into engineering). This can create higher job satisfaction.<sup>17</sup>

## RISKS

Larger bundles are not always better from the buyer's perspective. Bundling is subject to the same diseconomies inherent in any organization; larger organizations involve more layers of management, less direct communication among decisionmakers, and more opportunities for divergent interests to emerge and dilute a single, unified vision in the organization. Any effort to bundle must offer benefits, like those above, that are large enough to offset these generic and ever-present diseconomies of size. When a buyer bundles activities that do not generate the kinds of economies discussed above, generic diseconomies of scale can easily yield increased cost or decreased performance.<sup>18</sup>

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<sup>17</sup>In addition, to the extent that larger providers are interested in bidding only on larger bundled contracts, bundling can lead to reduced personnel turnover through the more comprehensive benefits packages (e.g., medical and retirement) that larger firms are generally able to offer their employees. A recent survey conducted by Dun & Bradstreet found that 81 percent of small businesses offered no retirement benefits, 64 percent offered no paid sick days, 61 percent offered no health benefits, 54 percent offered no paid holidays, and 50 percent offered no paid vacation days (Gregory, 1998).

<sup>18</sup>Another potential drawback to bundling is the competitive "lock-in" effect that comes from committing a greater degree of control over key services to a single service provider. Bundling may increase the level of effort a buyer must expend to disentangle itself from an existing relationship with a provider (without adversely affecting operations) if the provider does not meet the buyer's needs. These increased switching costs potentially erode the buyer's ability to manage performance as desired. To avoid this "lock-in" effect, a buyer can give at least a small part of its work to one or more additional service providers. This may convey to the primary provider that it should not take its position for granted.

We are grateful to William Kovacic for the following illustration. Twenty years ago, it was common for large commercial enterprises to bundle legal services, relying on a single large law firm to handle most of their counseling and litigation needs. Today, major companies still may give a large amount of work to one law firm, but they often spread the business around more than they did in the past. Increasingly, they hold auctions to obtain legal counsel for specific projects, or they diversify the range of law firms retained to perform specific tasks.

For example, when bundles become so large that they exceed the core capabilities or capacities of potential providers, buyers run the risk of receiving poor performance or incurring an unnecessarily high cost for some activities in the bundles.<sup>19</sup> Bundles can include such a broad set of services that many leading providers are unable or unwilling to bid (e.g., facility management services plus aircraft maintenance or information technology services), limiting buyers' abilities to realize the performance and savings benefits expected from bundling. Similarly, buyers that bundle services across too broad a geographic area may find that it is difficult to find firms that can absorb the workload and provide consistently good service across the entire area. As discussed above, the magnitude of this risk varies by service, buyer goals, and acquisition strategy. For example, many leading facility management providers use the same elevator maintenance service subcontractor at each of their buyers' sites. However, several providers told us that they have difficulty finding a similarly consistent national provider of janitorial or grounds-keeping services. These large providers tend to subcontract locally or regionally for these services.<sup>20</sup>

Several buyers that we interviewed are concerned about this risk and have taken deliberate steps to mitigate it. For example, they have separate bundles for closely related groups of services that fall within the bounds of typical core capabilities of the leading providers; they have chosen individual providers for services within distinct geographic regions (e.g., regionalization of property management services);<sup>21</sup> and they have segregated third-party logistics services by product lines or manufacturing plants. Other buyers have pursued large, comprehensive bundles by encouraging (sometimes almost dictating) the formation of strategic alliances among providers that

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<sup>19</sup>The British Ministry of Defense, which previously contracted for very large diverse bundles of services, is now backing away from its comprehensive installation bundles, separating facility management services from aircraft support and airfield operations.

<sup>20</sup>Moore et al. gave additional examples and a more detailed discussion of the risks associated with different bundling strategies in a 1997 briefing.

<sup>21</sup>However, one buyer we interviewed that has several regional facility management contracts is planning to reduce the number of providers with whom it works. One advantage of the regionalization approach is that it provides an opportunity to benchmark the cost and performance of similar services across providers, creating a fairly competitive environment that encourages innovation and continuous improvement among the providers.

were specifically chosen because of their capabilities to provide certain pieces of the bundled services. However, such alliances can be difficult to set up and sustain over time. They generally require a lot of work on the part of the buyer and providers (who may be competitors in some activities or regions), potentially offsetting some of the benefits associated with the larger bundle.