A BETTER WAY TO PAY

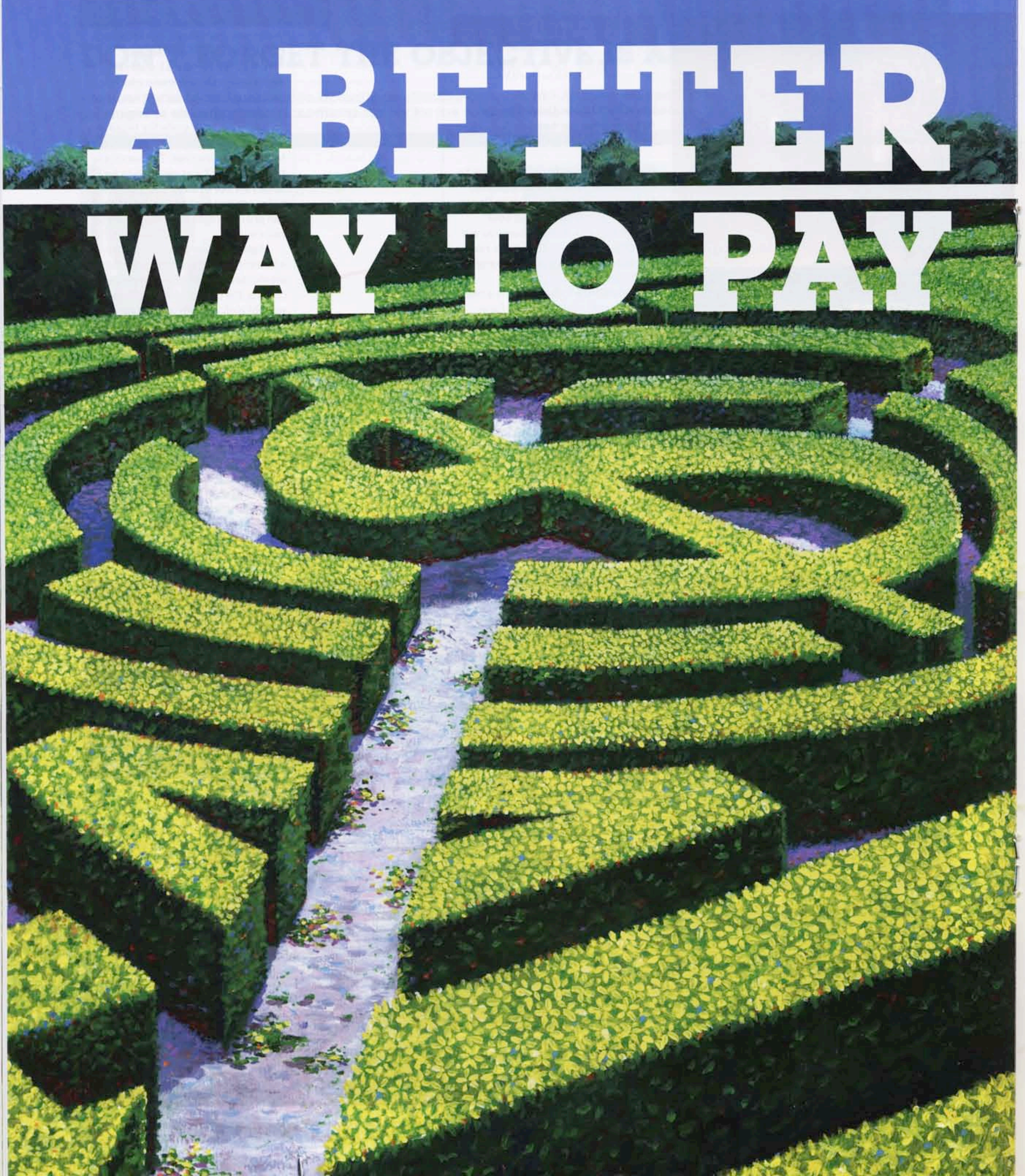


IMAGE: PHOTOLIBRARY.COM

FEATURE

Creative agency remuneration has long been an area of dispute, and the involvement of procurement in pay negotiations is intensifying things. **Nina Hendy** looks at common models, and asks if they need reform

Australia's creative agencies might be great at coming up with the 'big idea', but finding the best way to charge for it is another matter entirely. Some of the most common remuneration systems include retainer fees, a variable fee based on the number of head hours it takes to service a client's account, project fees, a percentage of media spend as commission – or a hybrid of these.

But all of these systems have flaws, with creative agencies in agreement that current remuneration models are problematic.

And yet, despite all of this, agencies and clients simply shrug their collective shoulders with the belief that a better system doesn't exist, and trudge on. After all, clients have long been dictating financial arrangements and agencies aren't keen to rock the boat by suggesting alternatives, particularly if it could mean losing business.

While the remuneration issue has been around for as long as anyone can remember, debate around remuneration models has intensified over the last few years as pay negotiations fall to clients' procurement departments, which are fronting up to the negotiation table with strict budgets. Their intention, of course, is to hire the agency for as little as possible, which doesn't bode well for results-driven outcomes, let alone a trusting client-agency relationship.

Darren Woolley, managing director of Trinity P3, is advocating for change, lamenting that the remuneration system is broken. He says there will be consequences to maintaining current remuneration models, fearing that the status quo will see agencies' margins continue to fall. This will ultimately make it more difficult to recruit new talent and retain existing talent, he says.

"Clients are paying more for administration, management and production than they are for ideas, which are massively undervalued," he argues. There is no incentive to create real value for clients. On the whole, results aren't rewarded. And the current systems rely heavily on clients trusting that agencies are charging fairly. Woolley also notes that current remuneration models offer no incentive to produce the best work an agency can.

"Not to mention that the profit margins that agencies are working under are so slim that they aren't sustainable. Something has to change."

Woolley has been working to find better alternatives because: "I'm sick of looking at remuneration agreements where agencies discount their fees just to land the account."

He says performance-based remuneration (PBR) combined with a retainer fee is the answer. He believes agencies should be remunerated based on the share of value a campaign creates, which he says is fairer. "All agencies want to get to the point where the agency can share in the value created by a campaign, but there's a whole lot of issues that get in the way. But imagine how much more incentivised an agency would be to create fantastic work if it was sharing the profits."

"Most large corporations have a performance bonus structure for the senior management team. All this would be doing is extending that to creative agencies, which I believe would make them more accountable, and ultimately would result in them producing better work."

He continues: "So many marketers tell me that they're ready to pay for the big idea, but in reality they are only paying around 5% to 7% for the creative idea and the rest is eaten up in production costs and the rest."

Woolley points to the 20% sales lift enjoyed by one brand that advertised during Network Ten hit series *MasterChef*. This meant the agency had done its job, achieving its targets for the client. "This is a prime opportunity for the agency to have increased its earnings. It deserved to be rewarded, but wasn't," he says.

The Clinic's Colin Wilson-Brown also advises clients and agencies on remuneration agreements. He agrees that remuneration should be tied to performance outcomes, but says a survey he conducted of a dozen large clients a couple of years ago found that only a third had performance-based incentives in place. "We definitely don't have the right or best system, but the industry has struggled to come up with an alternative. The default position is based on hours rather than output.

"Currently, the only way that agencies can get their fees up is by arguing for more time. But this isn't always what the client wants. Sometimes, they want different people working on their account, or to use different mediums," Wilson-Brown says.

Phil McDonald, managing director of George Patterson Y&R Sydney, admits the current remuneration system is broken, but doesn't know what the alternative is. Most of his clients are on retainers, which are calculated using a percentage of people's time. "The problem is it's very difficult for anyone to really know, at the start of a relationship, just how much time is required to provide effective advertising solutions, let alone have a procurement department decide that," he explains.

But retainers work fine for brand strategist Hans Hulsbosch, who says they are a fair and transparent system. "I don't think incentive payments would work as it would put extra pressure on the clients. I don't think there's any point in being greedy because if you do good work, then the money follows."

> "PROCUREMENT DEPARTMENTS OFTEN VIEW THE PROCESS OF SETTING THE PRICE… AS BEING SIMILAR TO BUYING NUTS AND BOLTS. THEIR MANTRA IS TO SAVE MONEY, WHICH HAS NOTHING TO DO WITH VALUE"
> **MALCOLM RANKIN, CEO, APRAIS**

Ad agency BMF avoids retainers. It has managed to cut PBR deals with more than half its clients. Martin Rippon, managing director of BMF, says the agency also operates a number of other models with clients, based on the nature, volume and predictability of the work. "Overall [PBRs] work; as long as you produce great work and deliver good service," he says.

Many agree that agency-client negotiations that are taking place are being complicated by procurement departments – and that agencies are being screwed on price.

Aprais, a company that is brought in to assess the client/agency relationship and offer advice on remuneration, says procurement involvement is having a negative effect on the outcome of the creative process.

Malcolm Rankin, CEO of Aprais, says: "Procurement departments often view the process of setting the price it will pay for an agency's services as being similar to buying nuts and bolts. Their mantra is to save money, which has got nothing to do with the value the client gets from the relationship. Then agencies become their own worst enemies because they are pressured to reduce the price – and often do so," Rankin says.

McDonald adds that while in theory, PBRs are a great idea, procurement departments are reluctant to allow them. "Some clients want a PBR element included in the fee, but accounting for fee upside for the agency is difficult and not always popular in client procurement departments.

"But procurement departments are incentivised to take out cost variables – so even if the agency and the marketing director want to put all the agency's income against sales results, this is going to be extremely hard to get through a procurement process, so they both revert to the tried and tested retainer model instead."

Clients also dangle the 'PBR carrot' in front of clients during the pitch process, but the offer often disappears once you win the business, bemoans director of ad agency The Works, Damian Pincus. He doesn't have a PBR client right now, but is open to the arrangement.

"To be honest, I think the larger agencies are struggling with remuneration more than the rest of us. I find that clients are always happy to pay for good quality work. What they get peeved off with is layers and layers of middle management just there to tick boxes."

Although, agencies admit that procurement departments are often successful in their bid to drive down price. Rippon's BMF admits cut-price deals are done, which he says affects the wider industry. He has sat on both sides of the fence, being a former marketing director and also part of the team that put together the current Advertising Federation of Australia Remuneration Guidelines.

"Many agencies have been either lazy, unprofessional, expedient or naïve. Short-termist agency heads will do a deal to win the business to please head office, aware that it will be impossible to deliver high quality work and an adequate level of service over a sustained period. Others – and these are not all smaller agencies – can be somewhat naïve in the face of a professional procurement team and give away more than they should."

Clients know that it's easy to bring your advertising agency fees down by shopping around, he says. "The bad news, though, is that you'll get a lower quality, highly-stressed junior team working on your business that will mean you, as the marketing person, will have a lot of explaining to do to your organisation on why the ads are late, look poor or aren't working," Rippon adds.

Woolley says he's often called by clients six to 12 months after a client-run pitch and told the agency is underperforming. "I tell them that before we go out there and find a new agency that we should look at the remuneration. It is not uncommon to find that the agency is being paid 20% to 30% less than they should be because they discounted to get the work. Then the agency has a high turnover of staff because they're burnt out and there is no measure of quality. It's a vicious cycle."

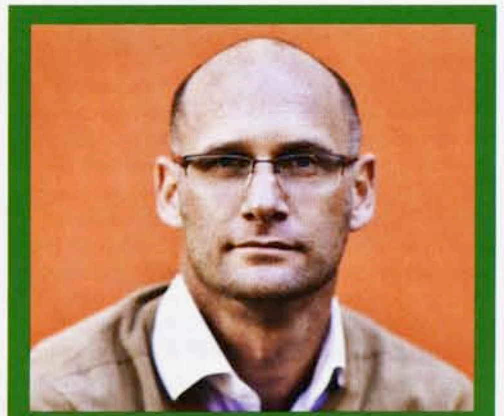
Many of those spoken to agreed that the solution to the remuneration issue needs to be tackled from the top, with many questioning why the Communications Council doesn't have a solution.

Peter McDonald, managing director of The Agency Register, says the Council needs to provide guidlines. "Guidance and support on pricing is a necessity. Should there not be a framework on where things start and finish?"

But The Communication Council's CEO, Daniel Leesong, says it can't make recommendations on price because it would be anti-competitive. "I doubt that recommended rates would bear much resemblance on what actually happens in the marketplace anyway. There's no doubt that agencies are reducing prices to pick up business. By how much varies substantially."

"ALL AGENCIES WANT TO (SHARE) IN THE VALUE CREATED BY A CAMPAIGN… BUT IMAGINE HOW INCENTIVISED AN AGENCY WOULD BE IF IT WAS SHARING IN THE CLIENT'S PROFITS."

DARREN WOOLLEY, MANAGING DIRECTOR, TRINITY P3



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But a client's ability to negotiate a cut-price deal isn't going to yield the best results, according to the Australian Association of National Advertisers (AANA). CEO Scott McClellan says smart marketers understand that cutting corners and saving money is a perceived benefit that will often catch up with them.

"Advertisers need to be quite precise about what it is they want from the relationship and how they plan to measure performance before they engage the agency. Failing to be clear about expectations will likely end in frustration for all parties and often cost the business money and/or market share," McClellan says.

The Agency Register's McDonald says the remuneration system becomes unstuck when the client isn't able to precisely convey what it is they want to buy from an agency. "Both parties need to revisit the scope of work quarterly or even monthly and build that into whatever formal arrangement they've got in place."

Perhaps Australia should be looking overseas for solutions. In the US, the American Association of Advertising Agencies – known widely as the 4As – is taking a stance on how agencies should be compensated for the first time. It agrees with Woolley, in that the foundation of all compensation discussions should be a value discussion.

Greg Stern, CEO and founding partner of a US ad agency, who helped put the 4A's document together told US industry publication *Advertising Age*: "Ultimately, the goal is to allow agencies to be paid on the basis of the results they achieve for clients. Right now, we're selling time."

Meanwhile, one high-profile advertiser has openly admitted the current remuneration system isn't sustainable. One of the world's most iconic brands, Coca Cola, led change when last year it announced it would change its methodology for compensating agencies, reverting to value-based compensation. Coke calculates the strategic challenge of the work, whether the agency is uniquely qualified to do the work, budget reality, share of work management and talent working on the business. It then uses these factors to determine a price for the work. Coke piloted the model in 2008 before rolling it out to 35 markets last year, with full implementation globally planned for 2011.

While Coke has been openly sharing its remuneration strategy at industry conventions overseas, whether it will drive other clients to implement their own strategy (and share the results with the industry) is yet to be seen.

Here in Australia, while most agree that change is needed, clients were unwilling to reveal the remuneration methods they prefer, with several large clients tight-lipped when approached for comment. But given the growing resentment at procurement departments leading negotiations, it's not surprising the topic is a thorny one.

The Communication Council's Leesong doesn't believe the remuneration issue is his issue to solve alone, saying: "It's up to the industry as a whole to bring about change. We all need to educate marketers, CEOs and CFOs about advertising and marketing being more than just a cost. This job is as big as painting the Sydney Harbour Bridge, but that doesn't mean it doesn't need to be done."

Woolley says ideally, the industry would have three or four value-based models they would use to negotiate fees with clients. "Agencies should look for ways to link remuneration to the value proposition and return on investment, not just based on the cost of delivering. They should use legal processes for IP protection as a way of demonstrating the value of the idea."

He believes the advertising sector can learn a lot from industries such as photography, architecture, theatre, music and publishing. "In most creative fields, the creative people are represented by an agency, which negotiates their fees and is incentivised by commission. Creative people take ownership of their ideas and protect their value through legal processes such as copyright, trademarks and patents in a way that reflects the value of the creative product."

PBRs are used by some Australian clients, but despite the constant talk over effectiveness, the system has never become an industry-wide standard.

Wilson-Brown worked on the Jaguar account back in his ad agency days. "The agency was paid its costs and also got a flat fee every time a car was sold. That meant that we only ever recommended advertising that we sincerely believe would work. We were held accountable."

But he says it's easy for clients not to pay.

"I've seen agencies marked down unfairly in appraisals so clients don't have to pay a bonus. If clients agree to pay an incentive then it should be budgeted for," Wilson-Brown says.

However, Woolley admits that PBRs can be dangerous in some cases. In a recent blog on the subject he revealed that when reviewing the agency remuneration of a client he noticed the contract included a PBR clause, but discovered that in the three years of the contract, no one had been able to calculate the dollar figure owed to the agency.

This was because more than a dozen KPI measures were in place. The person who designed the system had left the company and no one else could determine the best way. And the cost of the research to calculate the PBR would cost more than double the value of the PBR payment.

"This is not rocket science. Look for the measures that are already in place and then choose no more than three relevant criteria that will align the agency rewards to the organisation or corporate objectives," he says.

Aprais' Rankin agrees PBRs are a good solution. If agencies achieve hard measures (sales, shares, etc), intermediate measures (brand health, awareness etc) and a pre-determined "Aprais score", they should be financially rewarded, he states.

Whether it's PBRs or other methods, change could be just around the corner. Rippon predicts that agencies will put forward a number of new models over the next few years, particularly as what constitutes advertising evolves rapidly.

Performance-based ideas, payment for ideas and licensing of copyright models will be tried and tested, Rippon says. "The bottom line will remain the same. You have an agency staff to pay and a certain number of dollars coming in. How you get those dollars will be up to the smarts of each agency," he says.

The answer lies in collective thinking, Rippon says. "Agencies pride themselves on their creative thinking; they should apply that to the remuneration models." Agencies will have to drive changes. All we can ask is that clients remain open to looking at new models, and be aware that, at the end of the day, you get what you pay for". ■

REMUNERATION MODELS

Very few agencies will use any one model exclusively, with hybrids of the models listed below commonplace:

Variable fees based on actual hours: Client is charged per head hour. Charge-out rates calculated to cover staff salary plus overhead factor and agreed profit margin.

PROS: This system allows flexibility and is relatively easy to administer.

CONS: Difficult for the advertiser to budget and agency to resource. It requires accurate time sheets, and can mean a lack of accountability and no incentive for efficiency.

Project fees: This is where an agency takes on a project for a pre-agreed fee, which is calculated based on head-hours and resources.

PROS: Makes it easy to control expenditure and reflects the needs of the marketer.

CONS: It can be difficult for an agency to staff up for a short project. It also encourages a short-term focus rather than long relationships.

Retainers: Agencies charge clients a monthly retainer fee for a fixed period of time, which is calculated by the perceived number of head hours it will take to service the account.

PROS: Encourages media-neutral solutions and the agency can resource accordingly because it knows its income.

CONS: Agencies aren't keen on retainers because they represent a fixed cost, making it near impossible for them to increase their earnings year-on-year.

Percentage of spend as commission: The income is determined by a percentage of the media purchases made for a client and is a mode used primarily in media buying.

PROS: This system is easy to calculate and administer, making it simple in the case of mainstream advertising.

CONS: Not appropriate where media is not a major component of the output, such as digital or direct marketing.

Less common models:

Scale fee and wins bonus: Agency paid a salary based on a fixed percentage of either sales or annual marketing budget.

Concept fee: A one-off fee to cover the development of the creative concept.

Licensing fees: Agency paid a reduced concept development fee and then agrees to pay a license fee for use of the concept once it has been approved.

Source: Trinity P3