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Annual rate setting – is it time to rethink your firm's approach?

A time-honoured approach to rate setting within law firms often has a negative impact on profitability, but a change of mindset and methodology can turn things around, writes Colin Jasper.

When it comes to setting rates for the new financial year, most firms have a well-established process.

This may involve some competitive benchmarking, an assessment of market conditions, perhaps some "partner soundings" and ultimately agreeing on a percentage increase that pushes rates – but not too hard.

This approach, while common, is highly damaging to the profitability of the firm.

A flawed approach

Competitive benchmarking – Imagine you had complete transparency on the rates all your competitors charged. What would you do with that information? Charge a little bit less? Position yourself in the middle? Price yourself just below the most expensive?

What if you are already the most expensive, but are still busy? Economics 101 would say you're not charging enough! Benchmarks assume the offers are completely equivalent, but this is rarely true in law. Some firms can justify a higher price and some firms can't.

Market conditions – In some markets, when conditions are soft, suppliers reduce the price to stimulate demand. This clearly is the not the case in legal. If the price was 10 per cent less, it's unlikely to encourage clients to expand litigation or to undertake additional acquisitions.

The other reason for considering market conditions is because of the impact on market share. If demand is weak, and other firms are undercutting our price, we will lose share. While this is what we are taught from basic economics, the research among law firms indicates it's not quite so straight forward[1]. While clients complain about price, they are far more likely to switch firms because of service, performance, or relationship issues than price.

Partner soundings – The primary cause of under-pricing within law firms is fear. Fear of missing out on a new matter. Fear of damaging a client relationship. Fear of rejection. This fear is most commonly manifested at the individual partner level, rather than at the overall firm level. And for good reason.

Partners receive a lot of feedback on price – and most of it's bad. Clients complain that the firm is expensive. When opportunities are lost, they are generally told it was price (although it rarely is). Neither of these are valid data points, yet if your daily interaction with the market tells you the price is too high, of course you will begin to believe it.

Percentage increase – The resulting, across-the-board percentage increase provides a far too generic recommendation. Rate setting should be focused on price optimisation and this requires drilling down to the value of each individual. In addition to assuming that last year's rates were "right", an across-the-board increase ignores that the relative value of individuals changes over time.

Some firms choose to charge all partners out at a single rate, but clients (and the market more broadly) recognise this as fallacy. In doing so the firm is pricing some partners out of the market (because they cannot justify that rate) while undercharging for other partners. Why reduce the financial performance of the firm as a whole, in order to communicate an equality that doesn't exist in practice?

The damage done

While inertia may discourage some firms from changing their approach to rate setting, I would encourage you to consider the damage caused.

Financial impact – No lever has a greater impact on the profitability of a firm than price. For a firm with revenue of $40 million, a 5 per cent change in price equates to an additional $2 million profit. This drives the financial health of the firm, which enables it to remain competitive in the market for talent, to reinvest in the development of its staff and to undertake pro bono work.

[1] Citi-Hildebrandt analysis of price elasticity in the legal market.

Law Council OF AUSTRALIA Legal Practice Section
AUSTRALASIAN Law Management Journal

Positioning – There is a symbiotic relationship between price and position. While price cannot significantly exceed the firm's market position, a continued reluctance to push price constrains the position the firm can occupy in the market. While most law firms want to be regarded as the best among their peers, they don't want to be seen as the most expensive. Yet price is the number one indicator of a firm's market position. If you wish to be seen as a market leader, your price must reflect that.

Winning work – Where the firm over-prices some resources it makes it difficult for them to remain competitive in their space. For this reason, it is so important to assess rates at a micro (individual) rather than macro (firm) level to enable all parts of the firm to build a sustainably successful practice.

Finding a better approach

If the current method is flawed, then how should law firms set their rates. The starting point is to recognise that pricing is a mechanism for rationing scarce resources (i.e. partner time) with a focus on profit optimisation. To this end – for each resource – the firm should focus on two key metrics.

Utilisation – In most firms there are partners, or practices, that are fully utilised year after year. They were busy last year. They are busy this year. They will be busy next year. While these partners and practices are often regarded as highly successful, from a pricing perspective they are failing. They are not charging enough.

There are partners I have interviewed who have complained about how busy they are. When asked what would happen if they put up their rate by 10 per cent, usually after a pause to consider (because they haven't considered it before) they indicate it would have little impact on their practice. That 10 per cent additional revenue is all profit.

Lost on price – The second important metric to look at is what proportion of opportunities are truly lost on price. Some practices rarely compete for work. The client has chosen the firm, before even obtaining an estimate (if they seek estimates at all).

For other practices the work is contested, but clients select the firm they think is best placed to help them, with price being a secondary consideration. If price is not influencing buying behaviour, why are rates being held back?

In assessing the proportion of work lost on price, firms need to go deeper than the anecdotal evidence provided to the firm, from clients, through partners. This is the least valid data available. Ideally, firms should have in place a strong, independent pitch debrief

Law Council OF AUSTRALIA Legal Practice Section
AUSTRALASIAN Law Management Journal

process (i.e. not conducted by the partner involved) that drills down into the firm's proposal relative to the winning firm.

While the client may initially indicate price was the difference, by probing on the understanding demonstrated, the solution proposed and the quality of the team – all relative to the winning bidder – then circling back to price, a different picture generally emerges. When lots of pitch debriefs have been conducted, valuable insights can be obtained on which work is price-sensitive and which work isn't.

The impact of price optimisation
Having observed firms that have changed their approach to rate setting, the impact can be substantial. One firm has enjoyed double-digit profit growth every year for six straight years. Another firm – in the first year of using this approach – increased its profits by 18 per cent.

Perhaps more profound is the impact on attitudes. There becomes a greater focus on delivering value and determining where the greatest value can be added. Fear is diminished as there becomes a greater acceptance that losing some clients based on price is healthy. If you never lose work based on price, you are clearly under-pricing.

With this, unhealthy pressure on individuals is diminished, as instead of trying to meet firm financial targets while satisfying all clients, partners accept that pricing is a means of rationing time rather than continuing to accept profit-destroying work from clients that are a poor fit.

Rather than being detrimental to clients, it encourages each part of the firm to focus on the services and the clients where they can add the most value, and therefore justify the highest rates.

So think about this question – where are you setting rates too high and where are you leaving money on the table?

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