Equipped Maintenance and Extended Warranties

Let’s begin with full disclosure - I don’t buy maintenance agreements or extended warranties of any for any type for any type of product; including cars, refrigerators, cell phones, computers, printers, couches, driveways or anything else. Some might argue that it is prudent to warranty some of these items. However, my view is that in the long-run, it doesn’t make sense.

Now don’t get me wrong; I think there is a place for the short-term standard warranty that you automatically get when buying a product. There is always the possibility that you could wind up with a “lemon.” But financing extended warranties may not be the best decision for your organization.

Extended maintenance agreements are financial instruments. A good CFO is always looking to save money and get the best return on investment. Below we examine the pros and cons of these products.

Pros

Perhaps the core motivation for buying equipment maintenance agreements is the ease of doing so. Buying from the same source is easy and you simply call that same company for service. You can count on them to keep the machine working. Let’s face it; no one gets fired for buying a warranty from a big name company.

Fear

There, I said it. This is the number one reason everyone buys warranties and maintenance agreements. The “sales consultant” will guarantee that you will be back in service within a certain number of hours or they will provide loner equipment if there is a breakdown. “If you don’t have a maintenance agreement, you won’t be a high priority and you will be at the mercy of busy scheduling,” is usually what is said.

But, do you really think this is true? If you have money waiting to pay a vendor on a time and expense basis, do you think that your increased revenue will be put in line behind all of those whose revenue is already booked – sometimes for years? Do you think that rental equipment won’t be available to you when you need it?

What if?

Then there are the dreaded “what if’s!” What if you don’t like the service technician(s) or they simply don’t provide the service that they used to? What if the company you bought the equipment from merges, sells or goes out of business? What if your own bio-medical people could have repaired the equipment more quickly and inexpensively than waiting on the technician or original equipment parts to show up? You can “what if” yourself into either side of virtually any decision.

So What Gives?

The truth is that most equipment maintenance agreements have very high profit margins built into them - sometimes up to 40% or 50%. In addition, the sales representative earns a nice commission from the sale of extended warranty or maintenance agreement. So if you wonder why the sales representatives sell so hard it is because they get paid well to put the fear of the unknown into your head.

Therefore What?

I believe in taking prudent, calculated risk when the odds are with you. The decision of how to deal with equipment risks depends on many factors including:

• Whether there are alternative vendors for the equipment;
• The type and value of the equipment;
• If there is only one source for replacement parts or if the parts are proprietary;
• If there is extensive software that requires updates that cannot be obtained without a service contract;
• The age of the equipment;
• The costs of bulbs and other high-dollar warranty items;
• If there are automatic renewal clauses or cancellation penalties in the contracts;
• If preventive maintenance is included in the contract;
• If consumables are included in the contract;
• The manufacturer's warranty versus what is covered by the maintenance agreement; and
• The organization's risk tolerance.

Where to Begin
The first thing that any organization should do in evaluating their financing options for their on-going equipment maintenance is to secure and inventory all of the outstanding contracts. If the hospital doesn’t already have all contracts in a contract management system, then this process may not be so easy.

Unfortunately departments can sometimes be territorial and often they do the maintenance agreement purchasing without any support. Sometimes they don’t want to share or give up what they have because of fear.

It is important that the inventory summary include the type of equipment, the manufacturer, the model number, the serial number, a description and any accessories used with the equipment. Copies of every contract should be kept in the contract management system. It can also be very useful to categorize all contracts by expiration date.

I recently helped a client with this process. The CEO was stunned to learn that his organization had equipment maintenance contracts on typewriters that were decades old. Generally, it is fairly easy to eliminate contracts that have become unnecessary, or should simply be self-insured and self-administered.

Review each contract carefully. Some are full-service - including hotline usage, maintenance, software updates and even consumables that could easily be purchased more economically elsewhere. Many contracts will include response times and terms for night and weekend service. Some include the terms for supplying loaner equipment.

It is essential that all contracts be provided to vendors that will bid on developing a bundled program. The terms must be apples to apples to the current contracts or at least explain the differences.

Some contracts cannot be bundled. These include elevator or escalator contracts, window washing or contracts that just provide consumables.

Now that you know what contracts you have, you can begin to decide how to best finance future maintenance. Add up the value of the contracts. You may be surprised to learn that the total values are in the hundreds of thousands or millions of dollars. The total value along with your organization’s risk tolerance will guide you in deciding the organization’s future course.

Alternatives
• Eliminate unneeded contracts and negotiate better terms for existing contracts;
• Bundle the contracts and use an insurer or other vendor to achieve immediate significant savings and perhaps a profit sharing based on total cost outlays;
• Partially self-fund the exposures and purchase a self-insured retention (SIR) or deductible program to cap the risk;
• Self-fund using a third-party claims administrator to manage expenses and provide alternatives; and/or
• Cancel all contracts and completely self-fund all future maintenance.

These alternatives are reviewed in detail below.
Alternative #1 - Negotiating a Better Deal
Before embarking on a new path, it is always a good idea to first try and negotiate a better existing deal - although you are probably playing against a stacked deck. The company that is selling the equipment has all of the important data about breakdowns, expected lifetime of parts and costs of services... and you have virtually none. Yes, they may be willing to give you a discount to keep a high margin contract, but is this the best you can do?

Alternative #2 - Bundling the Contracts
It is easy to find a vendor, either a large provider or an insurance company, to bundle the contracts into a single program which will provide cost savings. Essentially, the vendor will convert all of your contracts into time and expense agreements.

By bundling contracts, efficiencies are created and up-front savings can range from 15% to 20% - depending on the size and mix of the contracts. In addition, profit sharing may be an available.

Transparency is important; no matter the vendor, you should be up-front with them. All maintenance should be on a set schedule and all costs accounted for. In this way, budgets are established and if you decide to take on risk, you can do so in an informed manner.

One advantage that large contract vendors have is that they have their own technicians to work on your equipment. Although this can be very cost effective - especially for the vendor, you can only use their technicians. If you choose this route, be sure you have the ability to opt out and choose your own service technicians.

Insurers will allow you to choose who will provide services and generally have optional providers if you don’t want to use your current vendors.

Whether you go the vendor route or choose an insurer, this is a good step towards organizing, budgeting and saving money. It won’t be an easy or quick project, but the savings will make it worthwhile.

One of the advantages of using an insurer to bundle contracts is obtaining access to the database that they have built. They can assist with buying decisions as they have a good idea about benchmark pricing. They can also help with decisions on whether to keep or purchase new equipment and assist with budgeting the costs of maintaining old equipment.

Alternative #3 - Partial Self-Funding
For larger equipment maintenance contract holders, those with contracts valued at $300,000 or more, moving toward self-funding is a good option to save money. However, self-insured retention programs come in all shapes and sizes. They may be as simple as sharing in the risk on an aggregate basis to taking on deductibles within an aggregated program or taking on stand-alone deductibles to cap each incident - like the loss of a $1,000,000 bulb.

In order to determine which program is right for your organization, begin by evaluating the overall program costs, the available options and your organization’s risk tolerance.

Alternative #4 - Self-Funding
This alternative may be the best option for organizations with millions of dollars in contracts. I am a proponent of prudently taking on educated risk. However, in this case doing it alone may be very costly. A third-party administrator (TPA) is a necessity. A good TPA can keep you from making mistakes and ensure you are properly budgeting the program. While it may be easy to budget 80% of the cost of the normal maintenance contract, in the long run, the TPA’s guidance can help to accurately budget maintenance costs.

TPA’s have knowledge of alternative service vendors, so that there are readily available alternatives in the event you become dissatisfied with a vendor. A good TPA can also save money, time and aggravation in finding alternative part sources. They deal with these situations daily. Their knowledge and guidance will save you far more than their fees.

For example, a hospital had the fan on the motherboard of an x-ray machine go out. The manufacturer told the hospital that they would have to replace the motherboard at a cost of $15,000. They called the TPA who located a fan, had it overnight delivered and talked the hospital’s tech through changing the fan - all for a cost of less than $100.
If your organization has a captive insurance company, you could fund the claims within the captive or you could simply act as a reinsurer to fund claims above a predetermined level. A bordereau agreement could be established with the captive to reimburse the insured/parent entity every month or quarter.

**Alternative #5 - Cancel All Agreements**

There is a very good chance that a large organization will save money with this option. However, you will be rolling the dice without the benefit of experience and seasoned guidance. I don’t recommend this option unless you have extensive knowledge and staff to manage the program long-term. Be sure and log service calls, issue purchase orders, bid major service events and track spending against budgets.

**Conclusion**

Maintenance agreements and extended warranties can be beneficial for some organizations. They have their place in financial budgeting, however, these agreements must be treated as what they are; financial instruments with critical services attached to them. Properly managing these agreements may yield low hanging fruit in the form of financial savings for your organization.
About the Author

Chris Miller is an Area Executive Vice President & Senior Director of the Gallagher National Healthcare Practice. Chris has 25 years experience in providing risk management consultation and brokerage services to hospitals and healthcare organizations. He is a former hospital board chairman, author, educator and consultant.

For more information, contact:

Chris Miller
Area Executive Vice President
Senior Director
Arthur J. Gallagher & Co.