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Upon preparing and analyzing the projected financial statements for UWP, the team decided to reassess some of the core assumptions in their business plan. In particular, they wondered whether they had priced their product fairly and whether there were ways to improve on their proposed incentive contract structure for the water vendors. On the latter, the team was concerned that the proposed revenue-sharing contract generated incentives for vendors to both underreport sales and neglect UWP's filter maintenance costs. The team recognized that the structure of the vendor contracts was interconnected with the price the company could charge for treated water, and jointly, these two variables would impact the company's reach in Dar es Salaam and beyond.

After some brainstorming, the team decided to consider two additional incentive contracts as possible alternatives to a revenue sharing agreement; each of these new contract arrangements had its advantages and disadvantages. (A) UWP could lease the slowsand filters to the water vendors for a fixed monthly fee, in effect allowing vendors to profit on any sales above the lease fee; or (B) UWP could share a proportion of its profits from clean water sales with the vendors, in effect making the vendors partners in the business.

Leasing was the simpler of the two options. In return for a fixed monthly fee to UWP, the vendors would receive the right to unlimited use of the filter to produce clean water. UWP would be responsible for all filter maintenance costs. Any revenues earned by the water vendors in excess of their filter lease fees were theirs to keep. Critically, the vendors would be responsible for pricing the water for end customers. The key advantage of this option was that it eliminated any need for UWP to audit vendor sales: under a revenue sharing or profit sharing agreement, vendors had an incentive to underreport sales to UWP in order to capture the full amount of underreported revenues.

With the leasing option, it was critical for UWP to determine the correct monthly lease price for water vendors. This price depended on the accuracy of the company's cost assumptions and the fairness of any profit margin the company decided to build into the lease price. A lease price too high would squeeze vendors too tightly, eventually driving them out of the business. Worse still, in this situation, vendors could be incented to dilute the filtered water in order to recover their costs through higher volumes. Alternatively, a lease price too low would allow vendors to eventually supplant UWP's filters with their own, driving UWP out of business.

To mitigate the risks of incorrect lease pricing on UWP's part, the company would need to have very good ground intelligence on the prices vendors were charging and their volume of sales. The

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Professors Karthik Ramanna and George Serafeim and Senior Researcher Aldo Sesia of the Global Research Group prepared this case. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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costs of obtaining such intelligence were unclear. Additionally, it would need to have excellent managers on staff to periodically analyze lease prices and renegotiate lease contracts. It was as yet uncertain whether UWP's proposed sales and management team would be capable of these tasks.

The second new alternative was profit sharing. Under this model, UWP was responsible for measuring and collecting all of the revenues water vendors earned. The revenues would be off-set against the company's operating and capital costs, and profits, if any, would be shared with the vendors in direct proportion to their contribution to revenues.[a] The key risk with profit sharing, as with revenue sharing, was underreporting: given their informational advantage, vendors would have the means and incentives to underreport revenues to UWP.

As with revenue sharing, profit sharing allowed UWP to retain control over the price end-customers were charged for the clean water, giving the company better control over its end-market. Further, profit sharing was akin to a partnering relationship between UWP and its vendors, with all the attendant benefits. Since vendors would be compensated from a firm-wide profit pool, they would be naturally incented to care about their filter equipment, their service technician, and more generally, the company's assets, including its brand.[b] This arrangement, it was expected, could give the vendors a sense of pride and ownership in UWP, which in turn could help create the sense of community that the founders had laid out as an objective in their business plan.

There was some concern among the founders, however, whether a profit sharing agreement would be considered fair by the water vendors. After all, under profit sharing, the vendors would be implicitly accountable for actions not under their control. This included any decisions made by management on operating costs (including wage structures, etc.) and any capital expenditure decisions (including depreciation policy). If the profit sharing approach were to be adopted, the team wondered whether to exclude at least some costs when computing the profit amount to be shared with water vendors. Such an arrangement was likely to be more agreeable to the vendors.

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[a] Specifically, the company would set aside some fraction of its total profits, say one-third, into a vendor compensation pool. Then, each vendor would receive that fraction of the vendor compensation pool that equaled the ratio of her sales to total company sales.

[b] In fact, the company estimated that if it chose a lease contract with water vendors, rather than profit sharing, the costs associated with water testing and filter maintenance would approximately double.