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Rethinking public-sector contract negotiations to secure value for taxpayers

Key negotiation practices can result in significant cost savings in public-sector procurement.

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There is tremendous value associated with public-sector procurement, given that departments and agencies purchase goods and services along a wide spectrum of industries, including defense, education, healthcare, and infrastructure. Across the globe, annual public-sector purchasing amounts to more than $9.5 trillion of goods and services. With so much value at stake, it would make sense for public-sector organizations to deploy similar negotiating and contracting practices as the private sector, where companies have developed procurement and contracting strategies to protect their bottom lines. Yet our experience shows that while using similar practices as the private sector would be beneficial, it's rare—and at times difficult—for public-sector organizations to do so. When they are able to utilize those strategies for major programs and systems contracts—including, but not limited to, infrastructure, large IT programs, and large service contracts—procurement departments see 20 to 40 percent savings on overall contracts, regardless of size. Across the globe, 20 to 40 percent of the $9.5 trillion could yield approximately $2 trillion to $4 trillion in savings for the tax payer. In addition to cost reduction, this type of strategic contracting has a number of other benefits, including enhanced vendor performance and service-level agreements, reduced supply risk, increased transparency, and more flexibility in the agreement execution—all of which provide greater value to taxpayers.

So, what is preventing public-sector organizations from implementing these practices? Many of the barriers, such as personnel fluctuations, contract and process complexities, lack of resources, limited stakeholder coordination, and a greater emphasis on transparency and competition, are a result of the unique context in which public-sector procurement operates. For instance, public-sector procurement teams must navigate purchasing's legal, structural, and political implications. And while these implications are typically found in representative democracies, they can also arise in other systems of government. Additional barriers to navigate are structural, legal, and political:

Structural. Many government programs have a sole-source relationship with manufacturers, so there are fewer opportunities to switch suppliers. In addition, governments employ fewer contract personnel and process requirements are more complex than industry, leading to longer time-to-award cycles and larger sets of stakeholders to engage.

Legal. Control is decentralized and requires strict compliance to regulations in pre-award and post-award phases. At the same time, suppliers must disclose data to the government in greater detail than exists in the public sector. For example, contract personnel are personally liable for certifying a price as "fair and reasonable" and face legal consequences if they sign off on a contract that does not meet the criteria.

Political. Contract timelines are often driven by factors outside the department's control—for instance, legislative timelines, turnover of political appointees, or shifting priorities. This is aligned with the fact that contract and operational decisions are often influenced by legislative interests. In other words, government budgets dictate what can be spent.

While public-sector procurement departments have unique and specific contexts and challenges, it is possible to implement practices from the private sector to improve processes, guide decision making, and help build negotiation skills and capabilities within the department. This in turn can result in cost reductions, improved negotiation outcomes, and speedier contracting.

How to unlock value through improved contracting: Ten lessons from the private sector

Despite the differences between the private and public sectors, our experience shows that there are ten strategic practices from the private sector that have crossover appeal, value, and viability in public-sector contracting. On their own they provide improvement, but together they have the greatest impact, helping ensure value for departments, agencies, and taxpayers.

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Know what your organization should pay—your 'number'—before entering negotiations
Too often, we see government contracting teams walk into a negotiation with a supplier without a detailed view of what the contract should cost. This means that the supplier's first offer anchors the negotiation, and the government must spend effort on "talking the supplier down." Offering the government's credible cost perspective first, or at the same time, prevents unilateral anchoring and can turn the tables so the onus is on the supplier, who must then "talk the government up." On the flip side, private-sector companies typically enter negotiations with an independent view of what they should pay, rather than letting the supplier take the lead.

Building that view doesn't need to involve a complicated cost model. For recurring activities, a good starting point is establishing a run rate using current-year actual expenses and then adjusting for increases and reductions in scope. Suppliers will inevitably do something similar and then apply markup, expecting to land somewhere in the middle on the final price. One government agency that deployed this approach on a recurring service contract managed to achieve 30 percent run-rate savings from one year to the next, even though the contract was similarly scoped.

Keep in mind the best alternative to a negotiated agreement
Governments sometimes get locked in sole-source situations based on a supplier owning the intellectual property or some previous commitment. This means that suppliers don't have to compete over price. As a consequence, there's no obvious best alternative to a negotiated agreement (BATNA) to leverage, which can put the government at a disadvantage. Therefore, public-sector contracting officers who choose to creatively generate a BATNA, or a BATNA proxy, can gain an edge during these conversations. The following approaches are examples of effective BATNA proxies:

— **Insourcing.** This approach utilizes existing personnel and resources. The government can exercise the right to bring some activities back in-house, reducing both top- and bottom-line potential on the contract.

— **Reduced unit counts.** Suppliers that believe that you are willing to reduce units will be more willing to ensure a deal is reached on price reductions rather than volume reductions, keeping in mind the impact on customers and service delivery. For equipment buyers, suppliers know that reduced unit counts also mean smaller sustainment contracts in the future.

— **Extension of current contract.** Suppliers are generally OK with the status quo. As a result, contract extensions are often missed opportunities to expand scope or to introduce new service improvements.

— **Inviting another supplier into the mix.** New competition is particularly effective because a competitor threatens income on the contract under negotiation as well as any future versions of the contract. This situation may not seem feasible in the short term (one year or less), but when redefining the time horizon to make the best program decision, such thinking can lead to more creative options.

There are also creative approaches to letting sole-source suppliers know you have credible alternative options, including a draft press release, a comment about visiting a city where a competitor is headquartered, or requesting data that supports an analysis of alternatives. Each can subtly let the incumbent supplier know that other viable options exist. However, it's important to note that BATNAs are only effective if the supplier believes there is intent to pursue an alternative path. To ensure that that understanding exists, the supplier's perception—which is based on the buyer's actions—must change, especially as it relates to how the process is managed, the communications shared with the supplier and others, the data leveraged, and the people involved. It's rarely a single item that changes this perception but rather the confluence of many behaviors.

Leverage publicly available data to understand your supplier

Government contracting officials often don't leverage publicly available information enough, which is common practice in the private sector. In the public sector, for example, a D-U-N-S number, which is a business-specific identification number provided by Dun & Bradstreet, can be used to pull financials on a supplier, helping buyers determine if the supplier is more motivated by revenue or profit. Buyers can then design strategies to pinpoint specific incentives.

Public records of earnings calls can also be a source of information and additional leverage. For example, a supplier might disclose important information on a quarterly earnings call (sometimes in response to clever questions from the analysts), or that a product or business unit is the most important growth engine going forward.

This strategy allows purchasing functions to anticipate which terms their suppliers will defend strongly and which they will be more likely to compromise on.

One agency deployed this effectively by showing that a supplier's stock price was more sensitive to revenue fluctuations than profit fluctuations, so it followed that they would compromise on markup. In another context, running a capital-market diagnostic on the supplier revealed a cash-flow concern for the quarter and empowered the program to target revenue over margin.

Stick to a timeline to avoid slower negotiations

Negotiations are a grind, comprising days or weeks (or sometimes even months) of analyses, meetings, and follow-up phone calls. The length at which these things can drag out can sometimes benefit the supplier's position—a supplier's partial information responses to government requests is often not accidental. Rather it is part of a deliberate effort to delay the timeline. Because the reputational cost of a service disruption is so high for government agencies, the government frequently accepts less favorable terms as deadlines loom (and they have historical negotiations to reflect on) to ensure continuous service. In addition, pressure to obligate funds in the year they are designated means there is pressure to "get on contract so we can get the money out the door." Suppliers take advantage of this weakness by postponing deadlines, requesting more time, and moving only as fast as the government is willing to push them. Borrowing tactics from the private sector, governments should stick to a timeline without ceding ground and do what's necessary to stay on track, such as initiating preliminary discussions, enforcing supplier schedules, and front-loading negotiation preparation in the schedule. As an alternative, governments can establish an upfront agreement that the existing contract will extend during negotiations and that the agreed-upon contract terms and price will be retroactively applied to that extension.

Keep incentive schemes simple, and tie them to performance and cost control

There is a tendency to overcomplicate incentive schemes, since suppliers prefer a complicated one with as much guaranteed as possible. They even model and track progress against potential fees using advanced models. The more complicated things are for them, the better, because they'll have more angles to work to maximize fees. In addition, metrics are often included that are not as meaningful as intended. Some metrics, while positive, may ultimately have very little to do with what constitutes substantial progress for the government. In the private sector, incentives tend to be more straightforward.

This public-sector trend is easily overcome. One agency simplified incentives so they were directly tied to the desired output of a maintenance contract: hours of utilization on an asset. In our experience, the most successful incentive schemes keep fees simple, rely on easily measured metrics, and link those metrics to the outputs that are most important on a given contract. For example, What are the most important service levels? Response time? Flying hours? Delivery schedules? Cost? Quality? Rather than designing complex gain-share clauses or delivery-delay penalties, agencies should prebake these elements into the reduced unit prices and tie the unit-payment schedule to the delivery schedule so payments are always expected. And while each contract is different, the incentives should always align with getting the agency what it wants.

One effective incentive entailed building a "cliff edge" penalty for late deliveries of low-cost, high-volume goods. In this scenario, the most important thing was that the government received the goods on time. The stiff penalty was designed to ensure the supplier would take action to meet those goals. At the very least, if it did not, the government would not overpay for minimal value. In fact, when the time came to execute, the supplier consistently missed the deadline. The agency didn't get the performance it wanted, but it did receive a steep discount from the contract-award price.

Looking at management incentives can reveal which metrics are most important to influence performance. In one situation, using proxy statements revealed what metrics management was compensated against and enabled the program to structure the contract to coordinate incentives, promoting deeper engagement within the agency.

Work off of the same cost model, and make sure it's clear how outputs are derived

One way to take the emotion out of negotiating prices is to not talk about prices. Structure the negotiation so you can reach an agreement on the outputs—but with full transparency of which "units" (eg, material, time, and personnel) will ultimately influence the cost of the contract.

In an ideal world, both the government and supplier would work off of the same cost model. The negotiation would be about which outputs the government needs and how the proposed cost structure delivers those outputs. If all parties agree on the underlying unit(s) required to deliver the output, and the vendor economics (ie, cost of the units) are well understood, then there should be no disagreements on the price of the contract.

Never stop asking for more transparency

It's hard to make a judgment call about value for money when you don't know what's included in the price. Too often, we see government contracting officials give up on demanding more transparency when the supplier starts to complain about the work required to provide it. Simply stated, suppliers know everything included in the cost of the contract. They most likely have a second contract model in the background that's different from the one they're sharing with you so they can run scenarios and make tweaks to revenue and profit forecasts. For example, vendors may charge top dollar for senior roles, although less experienced and more junior employees are doing the execution.

We've seen multiple agencies relentlessly push for transparency on specific contract items that ultimately revealed modeling errors that involved millions of dollars. In each of these situations, the government gained leverage because it either meant the supplier knew about the error and didn't tell the government or that they were negligent in building and approving their model. Either scenario put the government in a strong position for the remainder of the negotiation.

Bridge tomorrow's prices with today's costs, and force transparency on what's different
Private-sector businesses have growth targets. Every year, an executive's personal compensation is tied to his or her ability to grow revenue or profits for his or her business unit. Every year, he or she will look to increase prices and volumes on contracts. Anchoring on today's actual run-rate costs can be an effective way to counter increases in recurring contracts. If the run rate in the proposal is higher, understand what drives the difference between the two. The answer will inevitably include "inflation"—but it's important to determine the type of inflation. Fluctuations in material costs could mean raw materials may be cheaper in the future. And if raises for government employees are below inflation, why should contractor wages increase at a faster rate? Bridging supplier bids to today's actual costs also increases transparency on the implied cost of any scope additions.

Demand year-on-year continuous improvement for recurring activities
There is a learning curve for all suppliers, and contracts should be structured and priced in line with that curve. This ensures the government is not overcommitting without continuous value and improvement. Including a commercial term for an assumed continuous improvement target is often enough to offset a supplier's inflation claims and forces them to commit to productivity improvements. One agency effectively implemented blanket assumptions for continuous year-on-year improvements as high as three percent included in a long-term contract. This practice can lead to several possibilities. For instance, it may be met with resistance from suppliers or suppliers may be willing to compromise elsewhere to avoid being subject to this kind of term. In this way, it becomes a multipronged negotiation strategy.

Apply a talent-to-value approach
Negotiation teams often have diverse backgrounds. Some members may have more experience, while others may have more capacity or capability. Aligning the highest-performing talent to the most valuable parts of the contract (those that are most likely to be successfully negotiated) is a core aspect of a winning strategy. Negotiation teams must understand the experience, capability, and capacity of each team member as well as the breakdown of the contract in terms of value (not to mention its negotiability) and then match talent accordingly. A two-by-two matrix with value and negotiability can be helpful in breaking down a contract and assigning negotiation team members.

Develop a strategy, and get all team members on board
One important step is tying all of these practices together into a cogent strategy that is understood by the entire negotiation team (and supporting business functions). One important element of the strategy should be aligning the team on how to deploy leverage. There are basically three types of leverage: positive (rewarding the supplier with something, such as new programs), negative (some punitive action, such as withholding new business from a supplier), or normative (using logic and analysis to justify a position). In most negotiations there is a list of several potential sources of leverage, and the strategy involves conscious decisions around the sequence of deployment and who deploys that particular element. It's equally important that the strategy is syndicated across the team and approved from the top down, which promotes speed, agility, and engagement.

Our research shows that it's the exception that government negotiation teams have thought through the real-life deployment of their leverage over time, so making this part of the strategy can have rewarding results. Ensuring upfront alignment of the plan will prevent the supplier from exploiting instances in which members of the same government team take differing positions on a given issue, thus weakening the government's negotiating position. It will also enable government negotiators to accelerate discussions, because they can limit the time needed for unnecessary syndication (given leadership has approved the strategy).

In one example, a strategy was developed bottom up by the working team, role modeled top down by leadership, and tested and refined using role-play scenarios. Role play was particularly effective in ensuring everyone on the team knew how their peers would react under pressure and could anticipate the arguments the supplier would make.

Public-sector procurement professionals have an opportunity to deliver more value to taxpayers and citizens at the local, state, and federal levels. But with that opportunity comes complex challenges. By taking a cue from the most applicable private-sector negotiation and contracting practices, public-sector procurement departments can identify significant opportunities to move beyond savings, ultimately creating more value through reallocated funds and enhanced vendor performance—for their organizations and citizens alike.

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