

# How to create win-win public outsourcing contracts

To structure and manage complex contracts with the private sector, governments must have a range of skills and expertise. Six success factors are critical to these efforts.

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The private sector plays an integral role in how governments deliver goods and services to their constituents. In 2015, contracts with the private sector comprised 29 percent of government spending across Organisation for Economic Co-operation and Development (OECD) countries, and this portion has remained consistent since 2007.<sup>1</sup> These agreements can be large and complex, span multiple years, and involve partial or complete outsourcing, privatization, or procurement of a particular good or service; examples include IT services, maintenance of defense platforms or prison operations, and trash collection.

Due to government reliance on private-sector vendors, effectively managing the contracting process is critical. When contracts are managed poorly, consequences can include cost overruns, financial problems with the private contractor, and poor service delivery. All of these issues share the same root cause: poorly structured individual contracts and inadequate procurement processes. The US Government Accountability Office (GAO) has included contract management in its list of high-risk items over the past couple of decades. A core task for governments, therefore, is to ensure the right conditions are in place for contracts to succeed.

Getting it right requires creating contracts that are mutually beneficial for governments and suppliers—a significant challenge for public-sector agencies. Not only are these contracts typically complex but insufficient coordination, expertise, and resources across departments can result in a lack of focus on the most important areas. In our experience, six success factors can help governments select the right partners, craft effective contracts, and manage the arrangement well from inception to delivery. Many government agencies will also need to build additional capabilities and expertise to support this process; but the payoff, in the form of improved supplier performance and better stewardship of public funds, can far exceed the investment.

### The benefits and risks of public-private contracts

Given the scope of goods and services that governments must provide, private-sector companies are often invaluable partners. In many cases, outsourcing has been beneficial for all parties, helping public-sector organizations to maintain service levels despite tight budgets and complete ambitious capital projects. In the United States, for example, the Georgia Department of Transportation contracted with C.W. Matthews to rebuild the Atlanta I-85 bridge, which was completed in only six weeks, thanks in part to performance incentives.<sup>2</sup> In Australia, the New South Wales (NSW) government used an online vendor management system to procure contingent labor for the Department of Education, which was able to make savings of nearly \$770,000 over a ten-month period.<sup>3</sup> These examples, among many others, highlight the benefit of tapping capital, efficiency, innovation, and private-sector capabilities, to help meet the public sector's complex needs.

When contracting relationships don't function properly, however, governments can be faced with not only additional costs and subpar service but also negative headlines that can draw the ire of constituents. The collapse of UK construction and services company Carillion, which held a number of large public-sector contracts that proved to be less profitable than expected, raised concerns about government procurement processes and whether the financial stability of vendors should be included in the selection criteria.<sup>4</sup> Such incidents reinforce the value at stake in getting public outsourcing right.

## Essential elements of win-win contracts

Our work with governments and private-sector clients has highlighted six key factors that can maximize the potential of public-sector outsourcing contracts. This list can be a valuable tool for procurement and acquisition leaders seeking to improve their contract processes.

### 1. Identify key outsourcing objectives and tailor the request for proposal (RFP) process accordingly

Before starting the tendering process, governments must clearly define the objectives they hope to achieve through outsourcing. For example, is the goal to reduce costs? Is it to introduce innovative solutions for improved customer service? Is it to improve speed and agility? Pinpointing the primary objective can ensure the RFP process produces the best solution and identifies the right supplier while keeping the program on track, particularly if priorities or costs change. Ensuring that a program's aims are clearly defined, measurable, and quantified can also provide agencies with a fact base to make trade-offs should government priorities change.

Once the objective is clear, it must be aligned with the procurement process. For instance, an agency buying commodity products (such as standardized medical equipment or office supplies) could use price-focused eAuctions to deliver quickly at low cost. When outsourcing a large-scale managed service (for example, the management of a waste water facility or a \$500 million IT project), a detailed RFP process emphasizing project delivery and risk mitigation would be a better fit.

For new and innovative projects, it might make sense to have two to three vendors pilot the approach first. Designing the RFP process around defined objectives may well involve challenging the status quo, since relying on routine approaches will not necessarily produce the best outcome.

### 2. Get the requirements right

Requirements can be the single most important factor in achieving successful procurements. A lack of clarity or specificity at the beginning of a project can lengthen schedules and expand budgets. The GAO's report on the rollout of Healthcare.gov, for example, found that the Centers for Medicare & Medicaid Services incurred significant delays and cost increases—up to fourfold in some cases—due to changing requirements in the program's duration. These cost overruns were caused in part by technical requirements that were unknown at the start of the contract.<sup>5</sup>

Governments should be aware of several factors when defining contract requirements. First, it is important to specify parameters at the right level of detail. In many cases, this task involves highlighting a program's outcomes rather than specifying the inputs. For instance, if an agency outsourced telephone support with the goal of improving availability, requirements that focus on uptime and response time will likely produce better outcomes than just focusing on staffing levels. This focus allows the private sector the flexibility to determine the most cost-effective and innovative way to deliver.

Second, getting the requirements right the first time is important. Ambiguity forces private-sector companies to build in a risk buffer, often inflating bids. To do this effectively, governments must have a good understanding of the cost implications of their requirement choices. Tools such as linear-

performance pricing and clean-sheet analysis, which are routinely used in the private sector, can help pinpoint “should-cost” pricing. Then this information can be used to make trade-offs between costs and other requirements.

Last, in long-term or complex contracts, requirements should be sufficiently flexible to accommodate unavoidable changes in demand. This leeway is particularly crucial in technology outsourcing since it will continue to advance significantly over the course of a typical three- or five-year contract. Similarly, pricing may need to be flexible, particularly for raw material prices that fluctuate with the market. Understanding these pricing and market dynamics and structuring contracts to accommodate them can prevent costly renegotiations, contractor financial difficulties, and overruns down the road.

### 3. Promote competition from the right mix of suppliers

Public-sector organizations often require “fair and open competition,” however, this standard is often not enough to ensure the best vendor is selected for a given project. For instance, an RFP that bundles sole-source and non-sole source goods may be competed “fairly and openly” and still result in a suboptimal outcome because only the sole-source provider can serve the entire scope and may not be the best vendor for the non-sole-source good. In a similar fashion, lengthy processes or onerous qualification requirements can effectively limit vendor pools, a risk particularly high for small businesses.

Government agencies must also consider how their processes supports their ideal market structure. For example, the NSW government designed its contingent labor program to successfully encourage participation of regional companies and small and medium-size enterprises through a number of design features, including a simple online portal that gives prospective suppliers the ability to apply at any time during the life of the contract. In addition, the program incorporated reduced insurance requirements for vendors.<sup>6</sup>

Goals such as integrating new, smaller, nonprofit or other nontraditional suppliers will often require the government to take on different roles (such as program integrator) or deploy new tools in the process. Using approaches such as vendor days can help the government understand how it can best enable its goals through these types of process innovations. In designing the process, government agencies should recognize and plan for how the market is likely to evolve during the tendering process and during the contract. The UK Ministry of Justice, for instance, had a clear objective to develop a diverse list of vendors when designing its Transforming Rehabilitation program. It succeeded in receiving more than 700 registrations of interest at the start, including many from the public and not-for-profit sectors. However, as the NAO reported, the desired market construct did not materialize as not-for-profit bidders were unable to achieve the desired economies of scale, take on sufficient risk, and verify their financial and commercial standing during the tendering process, with only 19 bidders completing the process and five regions where there was only one compliant bid.<sup>7</sup>

Governments should carefully consider the criteria used to evaluate supplier bids. If the primary objective is cost savings, it makes sense to focus on price; if the project is particularly risky, it may be worth emphasizing capabilities or performance. Indeed, evaluating technical ability may require

innovative approaches. For instance, in some IT tenders, “bake offs” are increasingly being used, whereby a short list of bidders is invited to develop prototypes in a two- to four-week process to demonstrate capabilities before the government selects a contractor for the full project.

#### 4. Align objectives with incentive mechanisms

Even when the right partner is selected, misaligned incentives and poor performance management can still undermine a project. For example, according to GAO, the US Citizenship and Immigration Services Transformation Program, which sought to enable electronic management of the immigration benefits process, faced multiple delays and cost overruns in part because of difficulties in monitoring contractors. In one case, the agency responsible for managing the contract lacked information and clearly defined metrics to measure contractor performance.<sup>8</sup>

Setting up effective vendor management is a difficult but important task in establishing successful relationships. At a base level, each party to any agreement must have incentives to “do the right thing” for the project at all times. When done well, these incentives can generate tremendous value. In the United Kingdom, the National Audit Office reports that the Crossrail program’s well-defined roles and responsibilities for different parties and a clear performance baseline continue to help facilitate collaboration among suppliers, reducing costs by £3 billion.<sup>9</sup>

While every agreement is unique, a number of principles can help achieve alignment between vendor and contractor:

- Clarify the responsibilities of each party and ensure accountability measures are in place.
- Be transparent about risks and ensure that their natural owners have the authority to mitigate. If the private sector is not well equipped to address risks, it can lead to cost overruns, for example, if higher volumes materialize.
- Include planned improvements in the contract where applicable, such as incorporating price efficiency improvements into the contract from the year they are expected.
- Use service-level agreements (SLAs) with something at stake (such as financial incentives) for the vendor to align them with your business objectives (such as service performance).
- Adjust the contract to align with the complexity and uncertainty of the work. An outcomes-based or firm-fixed-price contract, for example, is more suitable for standardized activities, whereas a time and materials contract may make more sense for a highly complex project where the output is not well defined.
- Align payment terms and schedules to the quantity and type of work being delivered for outcome-based and firm-fixed-price contracts. In facilities construction, where vendors typically have upfront costs, a contract that only allows “per time of usage” pricing will require a vendor to cover its capital expenditures on a variable cost basis. This approach can lead to inflated rates if the contract is renewed.

## 5. Ensure sufficient data transparency and ensure it is used well

In our experience, many problems in outsourcing arrangements stem from an asymmetry of information and overall lack of communication from both parties. Without a “single version of the truth,” contractors and public-sector officials can unwittingly pull in different directions, particularly if there are different views on last price break opportunities, price paid, and volume forecasts. The GAO, for instance, highlighted the risks of inconsistent data on Department of Defense contract management and future spending.<sup>10</sup>

To make contracted partnerships successful, transparency around data and information is critical. While this doesn’t mean contractors should have unlimited access to government data or vice versa, it does mean governments and contractors should share relevant data, such as cost models, and have a shared understanding of where the risk lies (including further downstream in the supply chain). Defining responsibility for data ownership and stewardship enables both governments and suppliers to function more effectively and quickly resolve any challenges and disputes should they arise.

In many cases, the problem lies not in the willingness to share information but in simply having the right analytics engine and data systems to support robust data management. Without sufficient rigor in data management, it can be more difficult to detect volume discrepancies and incorrect pricing.

## 6. Retain in-house capabilities to monitor contracts and ensure appropriate governance

The government’s responsibility for outcomes does not end once a contract is signed. However, given pressures on public-sector budgets, the retained organization can sometimes be inadequate to monitor contracts. Singapore’s Auditor-General Office, for example, found that the Ministry of Health made payments to contractors without verifying that costs were reasonable. Critics continue to call for investments in training on public procurement within that department.<sup>11</sup>

Further, public-sector staff may rotate to other departments during contracts, especially those of longer duration. In such instances, institutional knowledge may be lost, both about an existing contract and the supplier landscape more generally. Ensuring that a dedicated team remains in place is therefore essential for monitoring performance and setting up subsequent contracts.

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A survey by the law firm Ashfords of UK local government officials found that more than 80 percent of respondents classified “sufficient in-house resource to monitor and measure performance and to undertake contract management” as important or highly important in “ensuring the success of outsourcing.”<sup>12</sup> To avoid an underperforming contract, a public-sector agency should set up a retained organization with the skills and capabilities to do three things:

- Monitor performance on the contract and enforce SLAs.
- Work with the contractor to incorporate new requirements or changes as needed throughout the life of the contract.
- Decide on key requirements and new designs or technical architecture for the next contract so that the government is not reliant on the incumbent to design the future solution.

### Next steps: How to execute

No matter how a government is currently performing on these six success factors, they can improve their ability to execute these win-win arrangements by focusing on core enablers. Procurement and acquisition leaders can determine their needs by answering questions in the following areas:

### Ensure the right relationship with rest of the business

- How aligned are procurement and acquisition with the internal customer?
- How often do they engage with program officers to determine whether third parties can help the department or agency meet its goals?
- Would you characterize the relationship between program officers and procurement and acquisition as a strategic “partnership” that works together on how vendors can best serve the mission or as a “customer-supplier” relationship (for example, the program officer requests and procurement and acquisition complies and delivers)?

### Retain the right talent and capabilities, appropriately aligned to contracts

- Have you segmented your contracts and matched teams and capabilities appropriately? For instance, large and complex agreements will likely need dedicated teams; for medium-sized contracts, proven methodologies and an at-scale industrial negotiating engine are important; with smaller contracts and commodities, strong category management and small contract aggregation will likely suffice.
- Are the procurement teams prepared to develop innovative solutions if required and not just accept the status quo?
- Does your team have an independent perspective on how much the procurement “should cost” based on vendor economics and how vendors will expend money to achieve the targets in the contract?



## Maintain rigorous processes and life cycle management

- Is procurement using the most effective processes and time line for the complexity of the goods and services being purchased?
- Do vendor performance reviews happen regularly and involve both program and procurement offices?
- Are change orders, modifications, and renewals handled with the same discipline as initial procurements?



In an era of tight budgets and heightened scrutiny on spending, the government's ability to extract more value from public-sector outsourcing is crucial. With targeted investments in cross-department coordination, capabilities, and performance monitoring, procurement and acquisition leaders will be positioned to achieve better outcomes. ■

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<sup>1</sup> "Size of public procurement," *Government at a glance 2017*, Organisation for Economic Co-operation and Development (OECD), OECD Publishing, Paris, 2017.

<sup>2</sup> Kevin Wilcox, "Georgia's I-85 span rebuilt and reopened faster than expected," *Magazine of The American Society of Civil Engineers*, 2017, asce.org.

<sup>3</sup> *Contingent workforce: management and procurement*, Audit Office of New South Wales, April 27, 2017, audit.nsw.gov.au.

<sup>4</sup> "Carillion's collapse exposes failings in tendering system," *Guardian*, January 15, 2018, theguardian.com.

<sup>5</sup> *Healthcare.gov: Ineffective planning and oversight practices underscore the need for improved contract management*, US Government Accountability Office (GAO), July 30, 2014, gao.gov.

<sup>6</sup> "NSW overhauls contingent workforce recruitment," *Government News*, April 9, 2013, governmentnews.com.au.

<sup>7</sup> *Transforming Rehabilitation*, National Audit Organization (NAO), April 28, 2016, nao.org.

<sup>8</sup> *Immigration benefits system: Significant risks in USCIS's efforts to develop its adjudication and case management system*, GAO, March 16, 2017, gao.gov; *Immigration benefits system: US Citizenship and Immigration Services can improve program management*, GAO, July 2016, gao.gov.

<sup>9</sup> *Crossrail*, NAO, January 24, 2014, nao.org.

<sup>10</sup> "DOD contract management," *High-risk series: Progress on many high-risk areas, while substantial efforts needed on others*, GAO, February 2017, gao.gov.

<sup>11</sup> *Report of the Auditor-General for the financial year 2016/7*, Auditor-General of the Republic of Singapore, 2017, ago.gov.sg.

<sup>12</sup> *Outsourcing public services across local government: survey report 2017*, Ashfords, 2017, ashfords.co.uk.

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