

Opening Remarks for the 23rd Annual Federal Networks Conference

February 17 – 18, 2010

Warren Suss, Conference Chairman

Good Morning. Welcome to the 23rd Annual Federal Networks Conference.

This year, Oliver Williamson, one of my professors from grad school, won the Nobel Prize for Economics. I've kept in touch with Williamson because the work he did on transaction cost economics was one of the handful things I learned in grad school that still seems relevant to my day-to-day work.

By the end of my brief remarks this morning, I hope you'll agree that Williamson's work is important and relevant to everyone in this room. Understanding Williamson's transaction cost framework can help federal IT industry executives, business developers, capture managers, and proposal managers improve your chances of winning some of the large upcoming contract opportunities we'll be discussing today and tomorrow. The government and military leaders of the federal IT community, as well as their acquisition officials, special program officers, and project managers can use Williamson's framework to get better results from these upcoming contracts. And an understanding of Williamson's thinking can help all of us, from both government and industry, deliver better, faster solutions for the end users of our technologies – government workers, warfighters, and citizens.

So bear with me. First, we've got to go over some vocabulary that may sound a bit academic. Second, for truth in advertising, realize from the outset, that we'll be talking about a framework, not a solution. It isn't like Williamson sat down and said, "I'm going to figure out how companies can win more government contracts", or "I'm going to help the leaders of the federal IT community have more successful programs." No, he wasn't really thinking about us at all. He was thinking about things like business behavior, markets, hierarchies, bureaucracies, and governance.

Williamson focused on transaction cost economics because traditional economics doesn't do a good job explaining how the real world works, and many

SUSS CONSULTING, INC.

...When You Need Results™

Noble Plaza, Suite 305, 801 Old York Road, Jenkintown, PA 19046 • (215) 884-5900 • (888) 984-5900 • Fax: (215) 884-1637 • info@sussconsulting.com
Washington, D.C. • (301) 587-5353 • Fax (301) 587-5982 • www.sussconsulting.com

market transactions can't be explained or understood using a pure market model. Williamson begins with three core concepts that we can all relate to. First, there's uncertainty. And in an area like federal IT, where the next generation of technology is only 18 months away, where we're introducing (or reintroducing) new strategies like Cloud Computing every few years, where the demands from our users seem to change every month, where implementation projects are full of technical, schedule, and cost surprises, and where ongoing operations can be anything but smooth, we understand uncertainty. We live it every day.

The second fundamental concept behind transaction cost economics is called "bounded rationality". Basically, it means that there are serious inherent limits to our ability to write contracts that anticipate all contingencies. No matter how good a contract we write, there's always going to be something that comes up that we can't anticipate. Now for simple transactions, like buying a commodity on the open market, the pure market model works – market competition generates a fair price, and buyers get what they asked for. But for more complex transactions, like those opportunities that our speakers will be talking about today and tomorrow, the pure market model falls apart. In our world of federal IT, there is no contract that will that will anticipate technology changes, new user requirements or operational glitches. Unpredictable situations, including those due to actions by the government, can drive up costs for industry. Likewise, unpredictable actions or failures to act by industry can interfere with the government's ability to get what they need, when they need it, for a fair price. "Bounded rationality" means that the best possible contract isn't good enough to deal with uncertainty.

The third fundamental principal behind transaction cost economics is that in an environment characterized by uncertainty and bounded rationality, opportunism can rear its ugly head. Opportunism means that players on both sides can take advantage of the situation and behave badly. In our world, the vendor can hold the government hostage, and can charge an arm and a leg to make a contract change to address a requirement or condition that nobody anticipated. The government can also unfairly hold up contractor payments due to a situation that is outside of the contractor's control or, even worse, one that is due to the government failing to take helpful or necessary actions. In the end, the result can generate transaction costs for the vendor, transaction costs for the government, or contract failure.

Transaction cost economics focuses on how markets and hierarchies are organized to economize on transaction costs in situations characterized by uncertainty, bounded rationality, and opportunism. One way markets evolve is that when transaction costs between two entities are high, say between two firms,

one firm can take over the other firm to achieve more efficient transactions within a single organization. By redrawing organizational boundaries, transactions that previously took place within markets, such as between companies doing business arms length using contracts, now take place within an organizational hierarchy. When transactions occur within an organization, you can achieve greater control. You don't have to write a detailed contract that anticipates all contingencies. You have the flexibility to give an employee an assignment, set up an interagency team, establish a program management organization (PMO), etc.

Unfortunately, there are no guarantees that moving transactions from markets to hierarchies will achieve desired efficiencies. Like death and taxes, transaction costs will always be with us. Just like we try to minimize taxes and put off death, economies and hierarchies both seek ways to minimize transaction costs. You'll never eliminate them. If you try to economize on transaction costs by merging two companies, and you don't have effective mechanisms for achieving greater efficiency by conducting transactions within one merged organization, rather than between organizations, you'd be better off, that is, more efficient, keeping an arm's length between two organizations. Those of you in the room who have been through difficult corporate and agency mergers know what I'm talking about. The driving economic principal, according to Williamson, is to minimize on transaction costs whether in markets or hierarchies. In markets, the primary way you can do this by developing more farsighted contracts. In hierarchies, the key is improved governance. We'll get back to both of these remedies.

Now, let's turn to the federal IT marketplace this year, and apply Williamson's framework to three important trends: In-sourcing, the shift from time and materials to fixed priced contracting, and the break up of large contracts, which I'll call segmentation.

Let's start with in-sourcing. As we enter a new decade, the government acquisition pendulum has been swinging away from staff augmentation – the one-for-one substitution of contractors for government personnel.

Stories are surfacing about agencies approaching on-site contractor personnel with a deal they can't refuse – either quit your contractor job and join the government or you're out of a job altogether. With the uncertainties of the current economy, along with the security and benefits associated with a federal government job, many on-site contractor personnel seem more than willing to take the government up on its offer. This trend will leave many staff augmentation

contractors with declining revenues on existing programs and will create serious challenges in building pipelines for future work.

In-sourcing isn't just creating turbulence on the contractor side. Agencies are also feeling the pinch. Some government executives are pushing so hard to in-source that, when their agencies don't succeed in re-badging existing contractors, they're sometimes replacing experienced, skilled contractor personnel with new hires who lack appropriate training and capabilities.

There are two main ways to justify the current trend towards in-sourcing. On the one hand, you can look at in-sourcing as a way for the government to save costs by cutting out staff augmentation contractor overhead and profits. On the other hand, you can look at in-sourcing as a way for the government to beef up their ability to control and manage their information technologies.

From a Williamson perspective, these two strategies have very different outcomes in terms of economizing on transaction costs. If you only focus on cutting out contractor overhead and profit, then you're saving some dollars, but probably not too many. There's no reason to believe that government agencies have significantly lower overhead rates than the aggressive customer-site overhead rates that contractors bid these days for staff augmentation work. Likewise, contractors need to shave profit margins to the bone to win these deals. Once you consider the costs of government benefits, training, and added management supervision, the fully loaded direct savings achieved by transferring a staff augmentation worker from a contractor payroll to a government payroll won't amount to much.

From a Williamson perspective, the real potential payoff from in-sourcing is to economize on transaction costs associated with managing large, complex IT projects and operations. Why? Because, in the federal IT space, when transaction costs go up, success rates on IT projects go down, and IT has become the primary tool for leveraging the productivity and effectiveness of the federal government. On the civil agency side, it's becoming more and more difficult to distinguish between the government and the information technology used to deliver government services. E-government is a reality. It's becoming the rule rather than the exception for web sites and the IT applications and systems behind them to determine the quality of the interactions, and the success of the transactions, between citizens, corporations, and our government. Even when citizens call up or visit a government office, the quality of the interaction and the ability to achieve a successful outcome are, to a large degree, a function of the design and operation of the government's networks, applications, web services and databases.

On the Defense Department side, it's well accepted that networks and IT systems need to be viewed as weapons systems. They are a vital part of military operations. The Defense Department needs to have assured, uninterrupted, "always on" network operations, and it's hard to name a military function that doesn't depend on effective IT applications and network services.

So if in-sourcing can help reduce uncertainty on federal IT projects and operations, if it can help to address, in real time, the unpredictable stuff that comes up on government IT contracts, if it can help make sure that government workers, citizens, and warfighters get quicker, better results from our IT investment, then in-sourcing is a great investment and a great strategy.

But in order to achieve these benefits, we've got to get beyond re-badging. We need to focus new, in-sourced resources on improved IT governance. In our space, transaction economies should allow us, industry and government working together, to respond more rapidly and flexibly to emerging user requirements. They should help the government achieve the benefits of promising new technologies earlier. They should enable us to move with greater speed and agility to surface operational problems and risks. They should help us to re-vector IT projects in trouble.

Now let's turn to the second trend – the shift from time and materials (T&M) to fixed pricing. Fixed pricing is an attempt to limit uncertainty and shift risks from the government to the contractor. I believe that we'll see a drive for fixed pricing on components of most large upcoming federal opportunities, including the Navy's NGEN, and DISA's GSM and NCES, as well as NIH's CIO-SP and CDC's CIMS.

For fixed pricing to work for anything other than commodities, two things must happen. First, there must be enough predictability to allow contractors to develop reasonably accurate demand estimates when they price their proposals. Otherwise, contractors will simply raise their prices to cover the uncertainty, or opt not to play altogether. Second, fixed priced offerings must be understandable and credible by both the government and industry sides, or else fixed pricing will increase uncertainty rather than reducing it, and will lead to all kinds of headaches, some of which I'll get back to in a minute.

First, let's look at the predictability of demand. This is extremely important, especially in an area like Cloud Computing where there's a requirement for big time up front investments in infrastructure, application development, and systems to support billing and operations, as well as the training, marketing and

sales costs associated with Cloud Computing product launches. The “build it and they will come” philosophy won’t pass muster in the rigorous corporate resource approval cycle. You need a strong business case, and one component of the business case – probably the most important one – is a credible demand forecast.

One solution here would be for the government to provide some guarantees of demand. This introduces a huge governance challenge. It means that the government needs to negotiate up-front commitments from users. In most cases, this isn’t going to happen. If anything, the government is moving in the other direction. Requirements contracting is all but dead except for major weapons systems. Instead, the government is moving more aggressively than ever to multiple-award, Indefinite Delivery, Indefinite Quantity (ID/IQ) contracts, where the only guarantee is that there are no guarantees.

The second best solution is to develop accurate demand forecasts. Now demand forecasting for government IT requirements is a tricky business. In the Defense Department, for example, you don’t know when, where, and how large the next military or peacekeeping operation will be. Even when mission requirements are relatively stable, it’s tough to predict demand for new IT solutions, such as Cloud Computing, across large, risk averse, highly decentralized federal agencies. Even for more focused user communities, such as those served by contracts like NGEN, GSM, or FCSSA, demand forecasting is an inherently tricky business.

But transaction costs don’t arise when problems are easy to solve. They arise when uncertainties, like demand forecasting, create real, tough challenges. Here’s an opportunity for both government and industry.

The government can help drive down uncertainty by providing better data that can be used by industry to generate more accurate demand forecasts. Here’s a case where open government and greater transparency can be translated into more efficient interactions between industry and government, leading to greater competition and lower prices. Unfortunately, many agencies have embraced multiple-award, ID/IQ contracting without appreciating the importance of providing better data to help reduce demand uncertainty.

On the industry side, of course, better demand forecasting, combined with clever bid strategies, helps companies win big government deals like the ones our speakers will be discussing. The company that does the best job building “reality models” of contract demand, and playing this off against the “evaluation model”

used to determine contract awards, will gain competitive advantage. Now you could call this opportunism, but you could also call it smart bidding.

Fixed pricing doesn't just exaggerate the risks of demand uncertainty; it also creates risks associated with bounded rationality. What happens when there's a mismatch between fixed priced offerings and the unpredictable requirements that will be placed on these contracts by government and military users? Here's an opening for opportunism, tempting the contractor to take advantage of the situation by demanding costly changes to tailor solutions to meet unanticipated requirements, perhaps to make up for initial low-ball fixed pricing used to win the contract in the first place. Or maybe the government becomes the bad guy, strong arming the contractor to make costly changes without offering them any additional compensation over the contracted fixed prices.

This bounded rationality challenge can be addressed with transaction cost reduction strategies on both the government and the industry sides. On the government side, there is a need for improved governance mechanisms to support a fair and rapid resolution when there are mismatches between fixed priced offerings and changing requirements. Here I'd argue that the government procurement shop can't do it alone. We need a change in behavior in government Program Management Organizations so that agencies avoid treating fixed priced contract components with a Time and Materials mentality. This means that government users need to come to quick resolution about what is and what is not included in fixed priced contract deliverable items and services. We must also change behavior to constrain government managers from introducing bureaucratic inefficiencies that are outside of the contractor's pre-defined offerings.

Since it's unlikely that the government will go as far as is needed to introduce new governance mechanisms to avoid haggling and opportunistic behavior, there's an opportunity for competitors to address the problem in their proposals. Companies can compete by doing a better, clearer job of defining what they'll deliver for a fixed price. They can also do a better job than the competition in designing processes to resolve mismatches between fixed priced offerings and changing, unpredictable government requirements. In Williamson's language, they can win the confidence of government buyers and best the competition by establishing more effective governance mechanisms to deal with bounded rationality.

The third big trend this year in federal IT will be segmentation - the break up of large end-to-end IT contracts. Segmenting the next generation of IT contracts will be the most dramatic change we'll see this year. When combined

with the two other trends we've just discussed – insourcing and fixed pricing – segmentation could be a real game changer.

The risks and rewards, from a Williamson perspective, are huge. The risks are most obvious. Instead of assigning a single contractor responsibility for end-to-end performance, there will be a need for new interfaces between the government and its new contractors, between each of the contractors, as well as between the new contractors, the government and the incumbents. The more interfaces, the more bounded rationality creates challenges, and the more chances for opportunistic behavior.

The risks are high, but the potential rewards are enormous. For decades, we've been wrestling with the mismatch between our slow moving, rigid federal procurement system and the need for agility, responsiveness, and speed created by our dynamic federal and military mission and technology environments. Will this new triumvirate – insourcing, fixed pricing, and segmentation – finally give us the solution?

The key to success here, taking a page from Williamson, will again be governance. This is a challenge and an opportunity for both the government and industry sides. Not only does the government need to establish an overall governance framework that will enable successful interactions between all players directly involved in this year's upcoming contracts, but the government needs to make major progress in governing its own fragmented user and IT management communities. It was tough enough getting them on board for last generation's less dynamic IT programs, and in many ways, we didn't succeed. Going forward, there's no way we can achieve meaningful progress in cloud computing, Web 2.0, and social networking without major improvements in IT management and user community governance to address issues ranging from funding enterprise infrastructure to setting standards and procedures that enable federated information sharing, to establishing enterprise-wide guidelines for the acceptance of distributed certification and accreditation testing.

So the government will need to improve its governance framework for the next generation of federal network and IT contracts. But industry must help the government operationalize this framework. In the new world of fixed pricing and segmentation, the contractor has as much skin in the governance game as the government. Your revenue and profitability will be tied to effective governance as well as to your pricing and technology strategies. Williamson talks about farsighted contracting as one strategy to achieving transactional economies, and farsighted proposals lead to farsighted contracts. As governance becomes more

central to the success of the next generation of federal IT contracts, award decisions will place more weight on the ability of bidders to put forward concrete, realistic, and innovative governance strategies and tactics. So the winners of the next generation of federal network initiatives we'll be discussing today and tomorrow will be the industry players who do the best job designing governance strategies and tactics that will work in the new world of fixed pricing and segmentation. And the winners will also be your agency customers, as well as the government workers, warfighters, and citizens who will rely on your technologies to help our nation thrive in a new decade of challenges and opportunities.

And a final note. Professor Williamson, congrats again on the prize. You deserve it. I hope my remarks here did you justice.

And to the audience, I've been thinking about doing a speech on Williamson for a few decades now. I hope it was helpful. Thanks for indulging me.

Warren Suss is President of Suss Consulting, Inc., headquartered in Jenkintown, Pennsylvania. The company has been delivering results for leading corporations in the federal government information technology community for over 26 years and now provides consulting services directly to federal agencies. Suss Consulting consists of over 70 senior professionals in federal IT, networks, healthcare IT and financial management.

Suss Consulting provides corporate clients with strategic planning, market research and opportunity capture support, including capture management, price-to-win, competitive analysis, proposal strategy, planning, management, editing, and writing. Specialty practice areas include Federal Health IT and Federal Financial Management. Suss Consulting has helped their corporate clients win over \$40 billion in new federal contracts.

The company has completed assignments directly for federal agencies in areas including technology strategy, information management, local service strategy, CIO organization design, video conferencing, IT investment review, VoIP planning and implementation, ERP services and systems, call centers, financial management, "Get to Green" support, and agency performance reporting. Suss Consulting holds a GSA Federal Supply Schedule 70 and a GSA MOBIS Schedule.

About Suss Consulting

What do you look for in a federal IT consulting firm?

A long, proven track record of delivering results with high value for its clients? Consultants who customize each project to address each client's unique objectives, constraints and culture? Trusted advisors with the backbone to make sure clients understand risks and costs as well as opportunities? Respected professionals you are proud to be associated with, who will never violate client non-disclosure agreements and are widely recognized in the industry for their trustworthiness and ethical standards of conduct?

Suss Consulting, Inc. has been delivering high value results with integrity for over twenty-seven years. Suss Consulting specializes in helping corporate clients identify and capture opportunities throughout the Defense Department and civil agency IT marketplace. Suss Consulting has helped their corporate clients win over \$40 billion in new federal contracts.

Suss Consulting provides five major services to corporate clients:

- **Proposal Support:** The Suss team has a winning track record on federal proposals, and provides a full range of support including proposal strategy, planning, management, editing, writing, and production.
- **Opportunity Capture:** These projects help clients bring in the business. They include full-range strategic and tactical capture management and sales assignments, as well as help in the design and implementation of business development, capture processes and federal marketing programs.
- **Market Research:** These projects help executives analyze current and emerging government requirements for the client's services and systems, and include market sizing, market segmentation, competitive analysis, and price-to-win.
- **Strategic Planning:** These projects help clients deliver on their potential through improved federal positioning, opportunity targeting, resource allocation, and sales/marketing management.
- **Federal Healthcare IT:** Suss Consulting offers in-depth support for companies seeking to position themselves for opportunities in the growing Federal Healthcare IT market segment.

Suss Consulting now also provides services directly to federal agencies. The company has completed assignments for the government in areas including technology strategy, information management, local service strategy, CIO organization design, IT investment review, "Get to Green" report preparation, VoIP implementation, ERP services and systems, call centers, federal financial management, performance reporting, and strategic management of human capital.

Suss Consulting has over seventy professionals including specialized staffs in proposal support, capture management, business development, sales/marketing, and market research. Our professionals have served as respected senior officials and executives in the largest agencies and government contractors.

Suss Consulting...When you need results. TM