

Senate State Government Committee Testimony – June 17, 2015

Strategic Sourcing & Reverse Auctions

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Thank you Chairman Folmer, Chairman Williams, and members of the committee for the opportunity to be with you today.

As I mentioned when I appeared before you not long ago, I am deeply grateful for this committee's unanimous support during my confirmation process and I consider it an honor to be able to work with you to improve the Commonwealth's core administrative functions and to reduce our costs.

Today, I've been asked to speak with you about two topics that were addressed briefly during my department's appropriations hearings and my confirmation hearing – strategic sourcing and reverse auctions.

Since these are essential components of Governor Wolf's GO TIME initiative in Pennsylvania, I am excited to discuss them both with you in greater detail, today.

To begin, I'd like to note that the debate surrounding strategic sourcing and reverse auctions is uniquely a public sector debate. There is no debate over strategic sourcing or reverse auctions in the private sector. Strategic sourcing and reverse auctions are long settled best practices in the commercial world. Every day in Pennsylvania and across the US, successful businesses, both large and small, are routinely participating in strategic sourcing and reverse auctions, because they work. Strategic sourcing and reverse auctions are applied to billions of dollars' worth of commercial transactions each year. They improve businesses' bottom lines.

So, when we say that we want our government to run "more like a business," part of what we're saying is that we want our government to employ best practices like strategic sourcing and reverse auctions to help keep costs under control.

So, what are they, really? How are they defined?

A reverse auction is a just a tool. It is a method of using online technology to negotiate a fair market price for goods or services. Think of eBay, but in reverse.

Instead of using the traditional single-round, sealed bidding process, the Commonwealth invites qualified suppliers to submit their prices for contracts in an online auction format.

Suppliers get immediate feedback online. They know immediately whether they have submitted a better price than their competitors, and they can choose whether to lower their own price in real time in an effort to win the contract. Competitive, real-time bidding continues until all participating suppliers have submitted their best pricing and a genuine market price for the contract has been established.

An online reverse auction is the very essence of a transparent, free market system. Prices are determined by the competition alone. It is also one of the most effective negotiating tools I've ever seen, and broadening its usage will save the Commonwealth millions of dollars.

Pennsylvania was the first state government ever to use reverse auctions – back when my friend, Mr. Kevin Shivers, whom I believe you'll be hearing from later in today's hearing, was part of Governor Ridge's press office.

In a 2001 press release, then DGS Secretary Gary Crowell, announced:

"The Internet has revolutionized the way we purchase goods in the Commonwealth. Pennsylvania was the first state to use online auctions. Not only have we streamlined the procurement process, but we've also managed to save taxpayers nearly \$13 million in the process. Several other states now are following our lead, and the Commonwealth has become the model for procurement in online auctions."

Altogether, Governor Ridge's administration purchased more than \$200 million worth of products and services through at least 22 online auctions.

After Governor Ridge, the Rendell administration continued to use reverse auctions as part of its strategic sourcing initiative. And in 2005, the Commonwealth invested in new SRM technology, enabling reverse auctions to be done in-house at a lower cost.

Unfortunately, between 2009 and about a month ago, the Commonwealth chose not to employ this proven, money-saving tool.

When I returned to DGS in January, I knew we needed to bring back reverse auctions as part of GO TIME and as soon as possible.

We already have.

The two reverse auctions that were held recently were for a Dept. of Corrections health services contract, and for road salt. Both were successful and together they yielded more than \$12 million in annual savings.

Now, we need to expand reverse auction usage broadly.

Reverse auctions are not appropriate for every contract, but they should be considered for every contract where the goods or services we are buying can be adequately specified and where we have multiple competing suppliers.

One key development in the marketplace over the last decade is that the cost to administer each auction has declined substantially as the technology has become more commonplace and easy to use.

As a result, it is now feasible to use reverse auctions for relatively small procurements. Whereas reverse auctions were once applicable only to large contracts worth \$500,000 or more, they can now be applied to contracts worth as little as \$20,000. This means that the Commonwealth can improve the

competition for our business and can achieve savings without necessarily aggregating all our volume or limiting opportunities for smaller suppliers to compete effectively.

Overall, reverse auctions represent a remarkably effective commercial tool. Using them provides greater fairness and transparency for suppliers and lower costs for taxpayers.

So, reverse auctions are a tool – a tool that can be deployed as part of a larger program to improve government procurement and as part of strategic sourcing, which is the second topic you have invited me to speak about today.

As you know, strategic sourcing is an essential component of Governor Wolf's GO TIME initiative. We believe that by reintroducing strategic sourcing to the Commonwealth this year, we can achieve \$100 million in cost savings.

In my view, there has been a significant confusion and misunderstanding surrounding the topic so I would like to clarify what strategic sourcing is, and what it is not.

Strategic sourcing is a systematic and fact-based approach for optimizing an organization's supply base and improving overall value.

Here's an example of how it works, IT Hardware:

Prior to strategic sourcing in 2003, the Commonwealth employed the traditional multiple-award bidding process for IT Hardware. The traditional process awards contracts to virtually every supplier who submits a bid. So, prior to strategic sourcing, DGS maintained a contract with more than 150 IT hardware suppliers. The agencies were left on their own to determine their own specifications; choose from among the 150 suppliers; and negotiate pricing based on their individual needs and individual quantities. The agencies did not benefit from the Commonwealth's combined leverage. The market treated the Commonwealth like a loosely affiliated collection of independent small to medium sized customers, and this was reflected in the pricing and terms that we received. Smaller agencies paid more than larger agencies for the same items, and the lack of hardware standardization across agencies and programs caused technical problems.

The vast majority of the 150 suppliers on the multiple-award contract did little or no direct business with Commonwealth agencies, but many of them did do business with local governments and school districts through the contract.

A few suppliers did nearly all of the business with Commonwealth agencies: Dell, Hewlett-Packard, IBM, and Compaq. These four multi-national corporations, none of whom were based in Pennsylvania, all enjoyed richer profits at the expense of Pennsylvania taxpayers because the Commonwealth lacked an enterprise strategy and approach.

Through strategic sourcing, in 2004 DGS worked with all the agencies to establish a Total Cost of Ownership model; more comprehensive commercial terms; common standard specifications for desktop and laptop choices; a standard hardware replacement cycle, etc. We leveraged our volume in an intensely competitive RFP process including a reverse auction and we saved more than \$19 million annually.

In 2005, we established a multiple-award, evergreen COSTARS contract that restored and preserved the ability of the majority of those 150 previous contract holders to do business with municipalities and school districts as they had been doing previously.

Strategic sourcing is not “sole sourcing.” Indeed, competition is essential to strategic sourcing, and the contracts that were awarded by the Commonwealth as a part of the first strategic sourcing initiative between 2003 and 2006 resulted from competition --- intense, unprecedented competition.

Strategic sourcing is good government.

Strategic sourcing means having a plan.

It means going to the marketplace with a thorough understanding of your requirements and of what really drives your total cost.

It means doing the hard work internally with the agencies to improve business operations.

It means communicating with suppliers to understand the marketplace and the solutions they offer.

It means being methodical and intentional about involving stakeholders in the effort to innovate; to improve the value that we get in return for taxpayer dollars.

It means aggregating our requirements, adopting enterprise-level standards and managing demand where it makes the most financial sense to do so.

Strategic Sourcing is an inseparable part of delivering a “Government that Works”.

As of today, we are just getting started with the GO TIME strategic sourcing effort. Because we do not have the necessary capacity and expertise in-house, we have issued an RFP for technical assistance. We received 8 competitive proposals just last Tuesday. Once we have completed evaluations and engaged the winning firm, we will begin working with the agencies and our suppliers to assess savings opportunities, choose supply and service categories, and develop specific strategies to reduce costs. The process is objective and data-driven. Once the initial analysis is complete in a few months, we will be happy to brief the Committee further on our progress.

In the meantime, Chairman Folmer recently encouraged me to reread the Legislative Budget and Finance Committee’s 2008 report on strategic sourcing in Pennsylvania and I have done so.

I would encourage everyone to read it in its entirety. In it, the very fine LBFC staff provided an independent assessment of the data and the methods involved in the Commonwealth’s first strategic sourcing program and found no significant errors. The report largely confirmed that the Commonwealth’s systematic effort to lower prices and control demand for goods and services resulted in \$500 million in reduced costs between 2003 and 2008.

The report also echoed concerns that were raised by a number of suppliers who were displaced when the Commonwealth implemented strategic sourcing the first time; and it outlined performance issues that emerged with a few of the contracts that were strategically sourced.

DGS is committed to addressing those concerns directly as we implement new programs and contracts going forward. We will approach strategic sourcing from a perspective that is informed by our own past experience and by the experiences of the majority of state governments and the federal government who have all also implemented strategic sourcing initiatives during the last 15 years. We intend to take a balanced approach.

For example, we will continue to expand on one of the key lessons learned during the first strategic sourcing initiative. We will continue to expand the COSTARS program. One key insight from our prior experience was that many of the small businesses that held statewide contracts did very little business directly with state agencies, but they did significant amounts of business with local municipalities, school districts and nonprofits through state contracts. We created the COSTARS program in 2005 specifically to preserve and enhance small businesses' ability to do business locally through state contract. Happily, COSTARS has continued to grow beyond everyone's expectations. As of this year, COSTARS has more than 8,100 local government entities, school districts and non-profits as members. There are 33 COSTARS contracts with more than 1,200 suppliers. Total business volume through COSTARS is approaching \$1 billion annually.

My request of this Committee is that we work together, and that we approach the challenge of reducing the Commonwealth's costs as a public policy challenge that is distinct from the challenges of promoting small business success and economic development in the Commonwealth overall.

To be sure, when an individual business loses a big contract it can be devastating; just as winning a big contract can be sustaining. Contracts are won and lost in our \$650 billion state economy every day, and we all want Pennsylvania's businesses to win more than they lose.

But Commonwealth spending on goods and services each year isn't near enough to drive outcomes for Pennsylvania businesses overall. Most Pennsylvania businesses don't do business directly with the Commonwealth. They do business with each other, and with consumers.

Commonwealth expenditures for goods and services represent less than one percent of the state's economy – and we would like to see that percentage continue to shrink as the economy grows and as we drive down the state's expenses.

Paying more than we have to for goods and services is not an economic development strategy, it is just the result of poor business decision making.

We must ensure that our procurement system is fairly administered and open to all. We should pursue policies that promote diversity and inclusion in our procurement system. But we do not have an obligation to adopt more costly strategies just so that some current suppliers are insulated from competition.

Our state government should adopt a coordinated program of strategic sourcing for the same reason that many Pennsylvania small businesses join organizations like the National Federation of Independent Businesses to take advantage of the volume-leveraged discounts they offer to their members.

Our state government should do strategic sourcing for the same reason that Pennsylvania families shop at Costco.

We don't have extra money to spend.

I hope this Committee will work with us to implement strategic sourcing and to improve our bottom line.

In its 2010 final report, the Senate Government Management and Cost Study Commission chaired by Senator Argall may have said it best. That report says, "The most important factor here is to ensure that the state is achieving the maximum leverage possible in its procurement actions."

I couldn't agree more. That's what well-run businesses do. That's what the NFIB promotes and provides as a major benefit for its member businesses. That's what we mean when we say we want our government to run more like a business.

Thank you once again for the opportunity to appear before you today. I'll be pleased to take your questions.