



Strategic Sourcing of IT Services by the US Government - Budgets and Trends

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Strategic Sourcing, largely beneficial, has always evoked cautionary reactions from the US Government and public at large. Currently US Government is caught between cutting budget spends and gaining greater efficiencies for public service. Strategic sourcing can not only help the US Government deliver better public services but also gain significant cost savings year on year. This paper attempts at breaking the taboo of outsourcing by showing that if properly managed, strategic sourcing can result in great cost savings while increasing cost and process efficiencies. This paper also further argues that there exists significant latent cost saving potential in US Government IT spending and illuminates and debates on approaches like insourcing and cloud computing.

Introduction

The global economic downturn of 2008 and the huge fiscal deficits incurred have intensified focus on government savings, efficiency, and effectiveness. The recession has led to unprecedented budget shortfalls, which in turn has taken its toll on budget allocation, staffing and project priorities. The need for food stamps, unemployment compensation, and integrated health care are greater than ever, further exacerbating the situation. With shrinking budgets and rising costs, today's state, local, and federal governments are experiencing significant cost pressures. Budget crunches has lead to the total federal workforce dropping by 14,000 employees in May 2013 bringing the number to 2,748,000, the lowest staffing levels in more than five years. With the budgets and workforce dropping, Governments are increasingly seeking external assistance and sourcing what they possibly can. As one social service director in California succinctly noted, "We don't have fire, police, schools- we contract out all of our work. Nothing is in-house and there is never an expectation that any of these things will be done in house". The observation clearly exemplifies that sourcing of services by Government is the need of the day, to drive efficiency in governmental operations and delivering effective services to its citizens. In a world where every dollar saved is paramount, the savings achieved through enhanced efficiency would further strengthen the government efforts in reviving the economy and focusing on promoting new businesses, increasing tax breaks and creating higher paying jobs for American citizens.

A look at Federal Government Spending

President Obama's fiscal year 2013 budget envisages spending on information technology (IT) to decrease from \$79.5 billion to \$78.9 billion, a decrease of 1.2% year on year or about \$586 million, in the fiscal year. A vast majority of the reduction will be coming from budget cuts in the Department of Defense. A small to moderate increase in IT spending would be visible in the Departments of Treasury, Health and Human Services, and Veterans Affairs. All these budget changes are aimed at President Obama's strategy of improving financial governance, enhancing healthcare services, and increasing the effectiveness of welfare schemes.

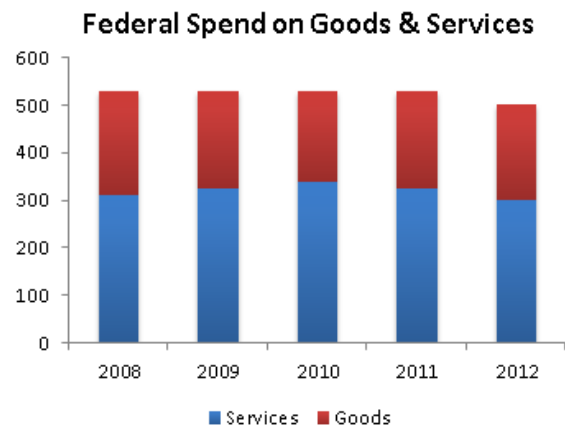


Figure 1 - Fed's spend on Goods & Services (Source: GAO Analysis)

After accounting for inflation, the spending on information technology has been essentially flat over the fiscal 2009-2013 period. The IT budget was part of the overall \$3.8 trillion fiscal 2013 budget. The budgets for procurement of Goods & Services have also been flat, slightly over US\$ 500 billion, with services accounting for nearly 60% of the budget (Figure 1). The federal budget shows annual deficits of more than \$600 billion, close to 4% of current GDP, every year up to 2017.

In fiscal year 2012, the US federal government spent \$307 billion to acquire services ranging from management and operation of government facilities as well as IT services to defense research and development. Leading American companies tend to save 4-15 percent annually by strategically sourcing the full range of services they require for their effective operations. A 4 percent savings applied to the \$307 billion spent by federal agencies equates to \$12 billion. This is the minimum savings the federal government can hope to achieve by bringing in private players as contractors. The gains from these savings can facilitate tax cuts to benefit the citizens at large.

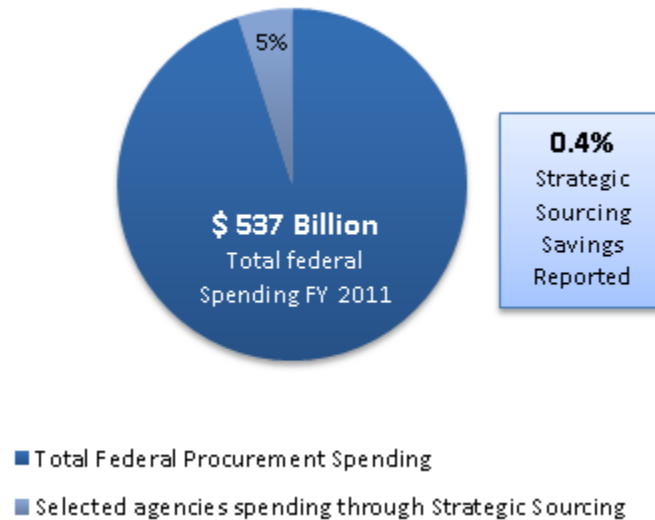


Figure 2 - Federal Procurement spending and savings – FY 2011

In fiscal year 2011, Departments of Defense (DOD), Homeland Security (DHS), and Veteran Affairs (VA) accounted for 80 per cent of the \$537 billion in federal procurement spending (Figure 2 and Figure 3). However, only about 5 percent or \$25.8 billion worth of Goods & Services was acquired through strategic sourcing efforts. The reported savings of \$1.8 billion was less than 0.5% of budget against a minimum of 4% that could have been achieved. This was a deep dent in the taxpayer’s pocket. In the same year, US Navy reported spending \$145 million and achieved savings of \$30 million through its strategic sourcing efforts. The reported savings was almost 21 percent of the spending, achieved through carefully leveraging strategic sourcing.

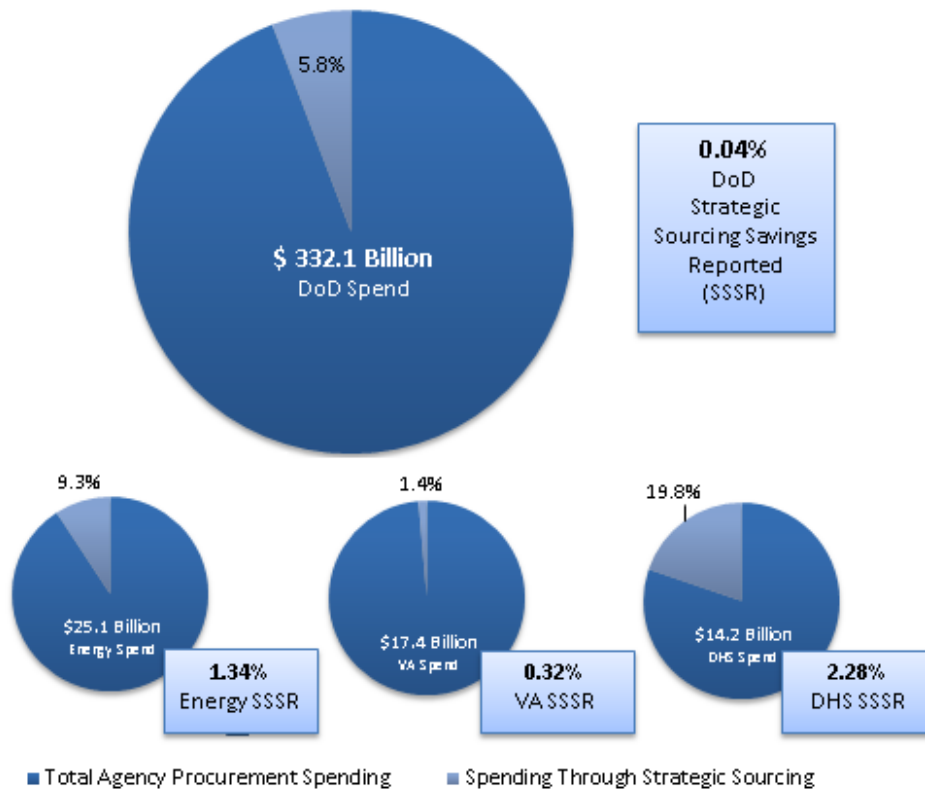


Figure 3 - Various Agencies Procurement spending and savings – FY 2011

Public agencies can learn some valuable lessons from the large multinationals. For example, Dell with an annual spend portfolio of \$55 billion in goods and services makes for an interesting analogy. Their centralized procurement model uses Global Category Managers (GCMs) who are responsible for knowing all the requirements, delivery needs, local markets and contracting necessities for each service. Each commodity (goods or service) is managed by developing detailed sourcing strategies. Procurement scenarios are analyzed to evaluate how suppliers react to their purchasing needs. Savings goals and metrics for success are determined from the bottom up and evaluated on a periodic basis. The result is an annual savings of 10 percent or \$5.5 billion. Wal-Mart, Pfizer, Delphi follow similar strategies to register annual savings between 6 to 15 percent. The government can cut back on their spending drastically by drawing up and implementing similar plans.

The top 10 categories purchased by the Government are mentioned below:

Category	Amount (USD Billion)	Examples of types of Services within Category
Professional Services	49.8	Legal, Engineering, Human Resources, Market Research
Automated Data Processing & Telecommunications	29.5	Data Entry, Telecommunications & Transmission, Programming, Cyber Security, Data Backup, Web Based Subscription, Help Desk
Building Construction	23.8	Construction of Storage, Parking, Utilities Facilities
Defense Systems Research & Development	22.0	Research & Development for systems such as aircraft, ships, tanks
Equipment Maintenance & Repair	20.0	Repair & Maintenance of plumbing, heating, waste disposal equipment and furniture
Management Support	18.2	Advertising, Accounting, Public Relations, Data Collection, Auditing
Housekeeping	12.2	Snow Removal, Landscaping, Garbage Collection, Pest Control
General Health Care	12.0	General medical services for Healthcare
Other defense Research and Development	9.5	Research and Development for items such as ammunition, textiles and fuels

Figure 4 - Top 10 Service Categories Purchased by Federal Government - Fiscal 2012

Without much difficulty, the US Government can still look sourcing some of its non-core requirements. A comprehensive spend analysis-providing knowledge about buyers, suppliers, understanding of how much is being spent on goods, and services would help the government in better leveraging their buying power. A broader aggregate approach across multiple agencies as opposed to numerous individual procurements would go a long way in reducing the costs involved in services acquisition. In the current financially difficult times, governments are looking to stay lean by introducing reforms in the direction of reducing the size of the public sector. Strategic sourcing of services is one definitive lever to achieve this goal.

Strategic Sourcing of IT Services in Federal Government

In 2005, the Office of Management and Budget (OMB) defined strategic outsourcing as “A structured process based on spends analysis, to make business decisions about acquiring commodities and services more efficiently and effectively. Governments can either outsource the provision of public services by purchasing goods and services from the private sector or non-governmental organizations, by including them in their own production chain or alternatively hire a company to directly provide public

goods and services to the citizen. The primary motivation behind the above would be to deliver the most cost effective model of governance with timely delivery of all obligations. Strategic outsourcing based on sound policies would most definitely lead to a reduction in public expenditure.”

It is expected that in fiscal 2013, 25 to 30% of the IT spend budget, amounting to around US\$ 20 billion will be used for strategic sourcing of IT services. Application services, including applications and internet, will account for the largest portion of the federal IT outsourcing budget, representing nearly 35 to 40% of the planned spend and reach around US\$ 8 billion by fiscal 2013.

Over the past five years, one has seen a rise in IT outsourcing initiatives in the public sector of over 25%. Despite this increased demand for services, the potential for such deals to be successful is challenged by concerns of labour unions and local interests. Fear that IT outsourcing initiatives will result in job losses in local communities, has gripped many sections of society. Labour unions have been very successful in capitalizing on fears that outsourcing transactions will result in jobs going overseas. In reality, however, industry research and deal experience reveals a more nuanced picture, as rebadged government employees that are often working with better technology, access to expertise and have a new career path support the majority of such deals. A sample-sourcing model from the Government is shown in Figure 5.

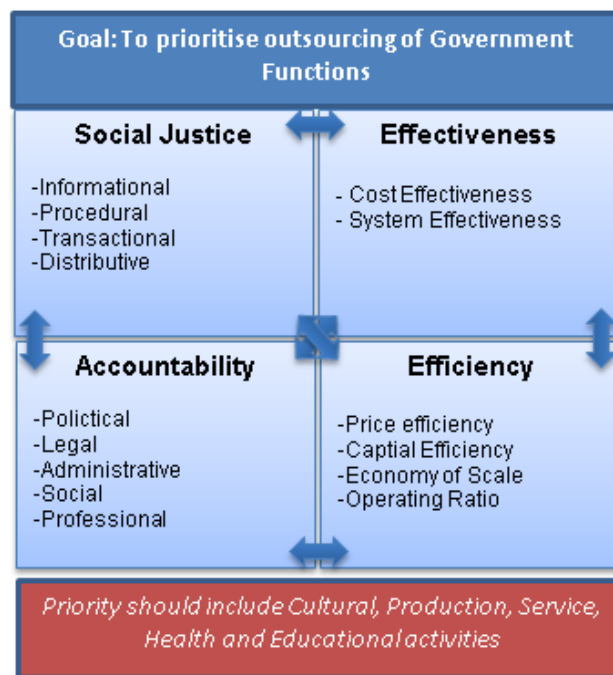


Figure 5 - Government Outsourcing Model

Despite concerns about jobs leaving local communities, people have realized that IT outsourcing, when properly executed, can bring better services at reduced cost for citizens. If managed properly, this savings results in the protection of other key jobs. The major factor is a shrinking federal technology workforce. A “significant” portion of the government’s technology workforce is approaching retirement

age. In addition, agencies have trouble attracting young technology workers because they cannot compete with the pay, benefits, and faster pace of corporate America. This makes the work related to technology enabled customer services and development and maintenance of old legacy applications, as high priority areas for federal government to source from outside. Thus, the Government is now depending more on the external expertise to ensure that the engines are running.

Insourcing – Is it an option?

Since 2012, after President Obama's State of the Union address, putting forward new tax proposals to reward companies that choose to invest or bring back jobs to the United States and to eliminate tax advantages for companies moving jobs overseas, a move towards insourcing of work to US for execution by US based workforce, has been initiated. Congress and the Obama Administration have taken numerous actions to promote "insourcing" or the use of government personnel to perform functions that contractors previously performed on behalf of federal agencies. A number of federal agencies like DOD, DHS and USAID have been engaged to catalyze the insourcing initiatives. The criterion that is being applied to decide on type of work to insource is being guided by the following rules:

- performed by government employees in the recent past;
- closely associated with the performance of "Inherently Governmental Functions";
- performed pursuant to a contract awarded on non-governmental basis;
- performed poorly by a contract (e.g., excess cost or poor service quality).

However, House Republicans have countered the Government Insourcing Initiative, citing the following reasons:

- Reduced competition, resulting in higher costs to U.S. taxpayer and lower quality of services
- Expansion of Government during a period requiring deficit reduction
- Detrimental Impact on Private Sector Jobs, particularly for small businesses

Unlike in the public sector, in private sector, the debate over Insourcing and Outsourcing is seen as more a political rhetoric rather than practical business and economic sense.

Federal IT Budget-2013 and steps to reduce cost

The federal IT budget recorded a 7.09% compound annual growth rate (CAGR) from 2001 to 2009. The next four years saw a -0.004% CAGR highlighting the severe budget constraints (Figure 6). The Office of Management and Budget's new approach, Techstat, to reviewing troubled government information technology projects saved the government \$4 billion in 2010 and 2011. The program relies on in-depth high-level meetings that evaluate schedule, cost, and performance of troubled IT projects and often

results in projects being halted, restructured, canceled, or accelerated in order to reduce costs. It focuses management attention on troubled projects and establishes clear action items to turn the projects around or terminate them. A budget savings of \$405 million was achieved by Techstat for the National Archives and Records Administration's (NARA) Electronic Records Archives investment. NARA took several corrective actions, including halting fiscal 2012 development funding, pending the completion of a strategic plan. From around 162 federal risky IT investments identified, about 19 percent have undergone TechStat reviews.

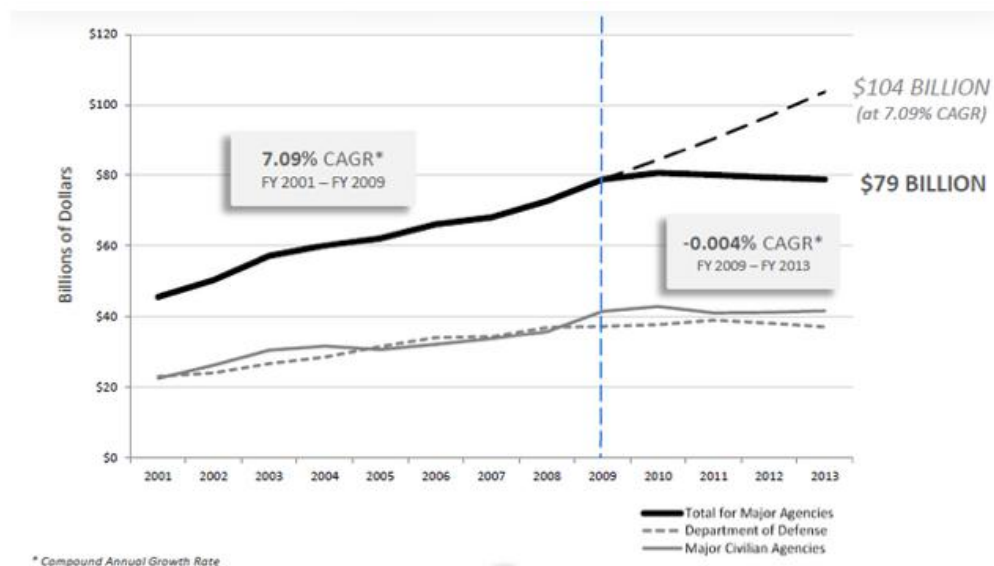


Figure 6 - Federal IT Spend Trend

Agency	IT Spending (in millions of dollars)			FY 12 to FY 13 Change	
	FY 2011 Actuals	FY 2012 Enacted	FY 2013 Budget	\$ Millions	Percentage
Department of Agriculture	\$2,459.50	\$2,492.50	\$2,572.40	\$79.90	3.20%
Department of Commerce	\$2,360.30	\$2,554.60	\$2,443.50	(\$111.10)	-4.30%
Department of Education	\$534.40	\$522.70	\$578.20	\$55.60	10.60%
Department of Energy	\$2,045.70	\$2,136.80	\$2,033.00	(\$103.80)	-4.90%
Department of Health and Human Services	\$6,594.90	\$6,960.40	\$7,139.40	\$179.00	2.60%
Department of Homeland Security	\$5,580.40	\$5,792.20	\$5,755.20	(\$37.00)	-0.60%
Department of Housing and Urban Development	\$318.40	\$489.40	\$392.30	(\$97.20)	-19.90%
Department of the Interior	\$1,012.30	\$993.70	\$965.10	(\$28.60)	-2.90%
Department of Justice	\$2,952.50	\$2,757.00	\$2,655.00	(\$102.00)	-3.70%
Department of Labor	\$613.50	\$607.50	\$610.70	\$3.30	0.50%
Department of State	\$1,402.20	\$1,412.70	\$1,345.30	(\$67.40)	-4.80%
U.S. Agency for International Development	\$106.20	\$90.00	\$112.40	\$22.40	24.90%
Department of Transportation	\$2,989.30	\$3,018.80	\$3,100.00	\$81.30	2.70%
Department of the Treasury	\$3,507.90	\$3,217.20	\$3,575.80	\$358.70	11.10%
Department of Veterans Affairs	\$3,036.40	\$3,111.40	\$3,327.40	\$216.10	6.90%
U.S. Army Corps of Engineers	\$550.40	\$582.40	\$566.40	(\$16.00)	-2.70%
Environmental Protection Agency	\$466.60	\$454.90	\$464.90	\$9.90	2.20%
General Services Administration	\$622.10	\$617.10	\$630.90	\$13.80	2.20%
National Aeronautics and Space Administration	\$1,686.90	\$1,461.60	\$1,461.50	(\$0.10)	0.00%
National Archives and Records Administration	\$165.00	\$106.00	\$99.50	(\$6.40)	-6.10%
National Science Foundation	\$98.60	\$98.70	\$97.30	(\$1.40)	-1.40%
Nuclear Regulatory Commission	\$164.70	\$155.90	\$151.40	(\$4.50)	-2.90%
Office of Personnel Management	\$78.60	\$72.20	\$65.00	(\$7.20)	-9.90%
Small Business Administration	\$114.20	\$101.90	\$111.60	\$9.70	9.50%
Smithsonian Institution	\$65.00	\$65.00	\$67.60	\$2.60	3.90%
Social Security Administration	\$1,567.60	\$1,370.10	\$1,380.40	\$10.30	0.80%
Subtotal for Major Civilian Agencies	\$41,094	\$41,243	\$41,702	+\$460	1.1%
Department of Defense	\$39,090	\$38,221	\$37,175	(\$1,046)	(2.7%)
Total IT Investments for Federal Government	\$80,183	\$79,464	\$78,878	(\$586)	(0.7%)

Figure 7 Federal IT Budget 2013

Across all government agencies, Techstat has saved \$1.4 billion by budget reduction, \$1.33 billion by eliminating duplication, another \$1 billion from accelerated delivery and \$0.153 billion by improved governance adding to a cost savings of more than \$4 billion to date. The increased future use of Techstat in the Health and Human Services’ (HHS) Unified Financial Management System: Modernization Program, the Veterans Affairs Department’s Benefits Legacy and Department of Homeland Security’ (DHS) Federal Emergency Management Agency Infrastructure would further add to cost savings.

It is apparent that the Federal Government, while reducing the overall budget due to economic realities in environment, has judiciously reallocated the budget to ensure a more inclusive growth. It is depending to realize a “higher bang for the buck”, by reducing wastage and making deployment of IT more aligned to its governance objectives. To achieve such a goal, access to right talent and expertise in the market through effective sourcing is necessary. The government cadre may not have the necessary skills in-house to achieve the goal.

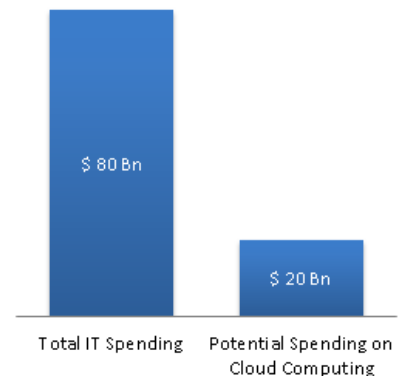
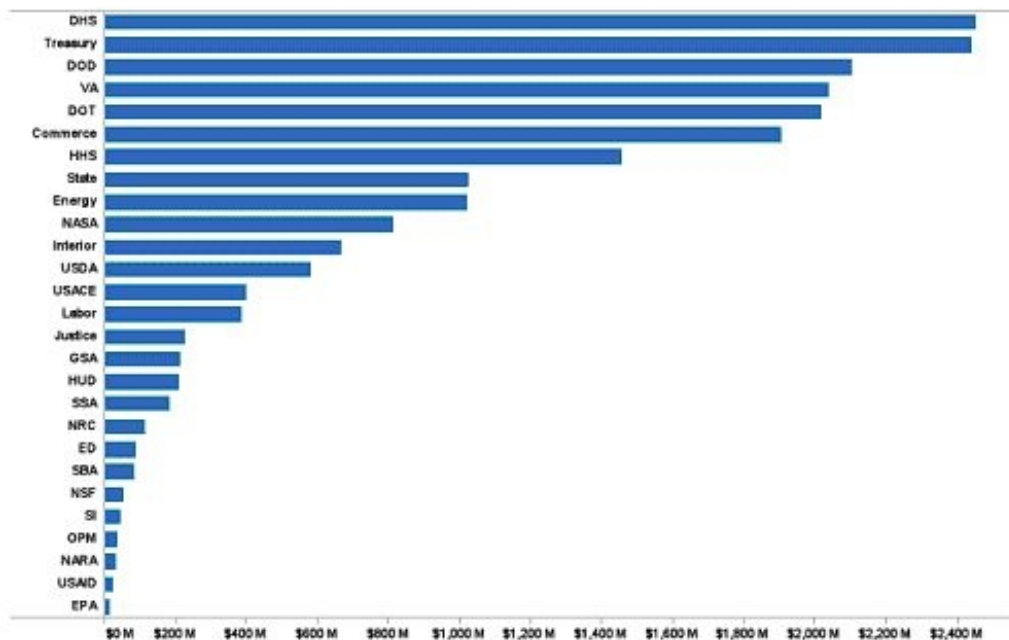


Figure 8 - OMB Estimate of Cloud Investment-2011

Relevance of Cloud Strategy to the Federal Government

The budget document attributed some of the reduction in federal IT spending on programs that have succeeded in consolidating data centers, moving to cloud computing and the success of the “TechStat” initiative, which involves reviews of agency IT investments by Office of Management & Budget (OMB) and the agency leadership. OMB in 2011 estimated that nearly 25% of the IT spend budget of federal government will be used for acquiring cloud based services.

OMB also indicated the Department of Homeland Security and Department of Treasury would be the two early movers in acquiring cloud-based services.



Source: Agency estimates reported to the Office of Management and Budget (OMB).

Figure 9 - OMB estimate of spend by agency-2011

The Federal Government’s current Information Technology (IT) environment is characterized by low asset utilization, a fragmented demand for resources, duplicative systems, environments which are difficult to manage, and long procurement lead times. These inefficiencies negatively impact the Federal Government’s ability to serve the American public. A Cloud Strategy along with rationalization through Data Center Consolidation and better Governance oversight is expected to mitigate few of these problems. For example, according to the 2013 budget:

- The Data Center Consolidation effort resulted in agencies committing to close nearly 1,100 data centers by 2015
- Agencies reported that 40 services have moved to the cloud which have reduced future projected spending on duplicative systems
- The TechStat initiative is expected to save a total of \$4 billion by the end of 2013 through along with face-to-face meetings with OMB and agency officials aimed at streamlining IT efforts.

Cloud computing offers the government an opportunity to be more efficient, agile, and innovative through an effective use of IT investments. By applying innovations developed in the private sector if an agency wants to launch a new innovative program, it can quickly do so by leveraging cloud infrastructure without having to acquire significant hardware, lowering both time and cost barriers to deployment.

This Federal Cloud Computing Strategy is designed to:

- Articulate the benefits, considerations, and trade-offs of cloud computing.
- Provide a decision framework and case examples to support agencies in migrating towards cloud computing.
- Highlight cloud computing implementation resources.
- Identify Federal Government activities, roles, and responsibilities for catalyzing cloud adoption.

Some of the benefits of the cloud over the current environment are listed below:

EFFICIENCY	
Cloud Benefits	Current Environment
<ul style="list-style-type: none"> • Improved asset utilization (server utilization > 60-70%) • Aggregated demand and accelerated system consolidation (e.g., Federal Data Center Consolidation Initiative) • Improved productivity in application development, application management, 	<ul style="list-style-type: none"> • Low asset utilization (server utilization < 30% typical) • Fragmented demand and duplicative systems • Difficult-to-manage systems
AGILITY	
Cloud Benefits	Current Environment
<ul style="list-style-type: none"> • Purchase "as-a-service" from trusted cloud providers • Near-instantaneous increases and reductions in capacity • More responsive to urgent agency needs 	<ul style="list-style-type: none"> • Years required to build data centers for new services • Months required to increase capacity of existing services
INNOVATION	
Cloud Benefits	Current Environment
<ul style="list-style-type: none"> • Shift focus from asset ownership to service management • Tap into private sector innovation • Encourages entrepreneurial culture • Better linked to emerging technologies 	<ul style="list-style-type: none"> • Burdened by asset management • De-coupled from private sector innovation engines • Risk-adverse culture

Table 1: Cloud benefits: Efficiency, Agility, Innovation

Conclusion

In the current economic turmoil, Federal Government has a tricky task of keeping spend budgets under control, while meeting the service requirements of its citizens. It requires them to be agile, innovative, and efficient in deploying technology judiciously to meet governance goals. Deployment of cloud computing technologies and other innovative technologies like social media etc are important. To roll out such initiative available technical skills in various government agencies is likely to fall short of the requirements. Strategic sourcing of such skills and expertise, from the private sector, is the only viable option, without wasting taxpayer money. In spite of the various political gesticulation and noises, raising the 'bogey' of job losses and calling for bringing back jobs through "insourcing", practical business and economic sense will prevail and will continue to drive strategic sourcing of services and deliver value to common citizens.

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