

Talking Points

# *What has your contract done for you lately?*

Saving costs through better contracting



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# Introduction

***The Government is using spending reductions to reduce the public sector deficit. The Spending Review mapped out £81bn of savings over the next few years.***

Accordingly, all Government departments have identified areas of major savings and are in the process of implementing plans to radically reduce spending. The methods to achieve the spending reductions, however, are rather less well defined.

One thing, though, is certain – the scale and extent of the required cuts mean that old approaches won't work. This time there is a compelling need to do things differently.

Taking the right approach to contracts is one essential aspect of delivering the significant savings that the Government needs to make. But before any substantial changes are made to major supplier contracts, we believe that Government departments should look at their entire contract portfolio with a different mind-set and ask themselves three fundamental questions:

- **Can we do the same for less?** In other words, can we deliver the same services but at less cost by being more efficient?
- **Can we do less for less?** In other words, are our contracts doing what we need them to do or do we need to reconfigure them?

- **Should we be doing things differently?**

In other words, do we need to effect radical change?

A new approach may also mean taking lessons from the private sector as well as gaining genuine cooperation across departments by deploying a multi-disciplinary approach to addressing the complexities of large supplier contracts.

Our experience suggests that there is a significant opportunity to realise savings of up to 15% in contracts that include complex pricing terms or subjective value – and in the present climate that is a prize that no department can afford not to claim.

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***There is a huge opportunity that has been identified both in central Government and beyond, but without a clear mandate, energy, focus and commitment, this cannot be delivered.***

*Efficiency Review by  
Sir Philip Green, October 2010*

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# Can we do the same for less? – Contract Efficiency

*In other words, can we deliver the same services but at less cost by being more efficient?*

Much emphasis in recent years has been on improving the procurement process in order to save costs through efficiencies. However, Government departments have historically paid much less attention to setting contracts up for success and effectively managing them once up and running. This often means that performance levels are not being tracked in the right way, performance data is frequently unavailable and suppliers are not being managed proactively to ensure that their delivery continues to meet the terms outlined in the contract.

When no one is paying attention, value erosion can come in many forms: increasing scope, delivery and quality failures; poor or inappropriate incentives; flawed planning; deficient demand management; ill-informed buying; deliberate contract manipulation; and miscommunication. The risk of value leakage rises proportionately as service delivery and pricing arrangements become more complex. The level of subjectivity in measuring supplier value also has an impact on value leakage.

Better value from contracts can be achieved by adopting a bottom-up approach – understanding the commercial realities and operation of the contract, reviewing the performance monitoring of the project and analysing cost data. This will identify where value for money is being eroded and highlight how value and savings can be captured.

This type of evidence based contract review includes:

- Review of planned commercial objectives at the business plan stage, how the contract actually works and the remuneration mechanism.
- Analysis of invoices and spend data to ascertain whether services and pricing are in line with the contract.
- Assessment of operational data that drives costs to identify value leakage.
- Identification of inefficiencies in the management processes.

Reviewing contractual agreements at this granular level can generate important cost savings. Our experience shows that significant value or savings can be achieved by taking specific steps across a portfolio of contracts:

- **Retrospective value** – errors in the pricing or value of goods and services already delivered under contracts that can be reclaimed directly from suppliers.
- **Prospective value** – errors in pricing or value that can be corrected for future contractual transactions with consequent savings obtained.
- **Value derived from improvements in business practices** – such as contract management processes, approval processes for contract call offs, variations to address cost and better monitoring of contract service performance that avoids unplanned-for cost increases.

There are clear benefits to thorough contract review:

- Saving significant costs.
- Achieving value by ensuring the public sector organisation receives the service levels specified in the contract.
- Improving the management and efficiency of service delivery.
- Improving the relationship with the service provider.

# Can we do less for less? – Contract Rescoping

We recommend that Government departments review their entire portfolio of supply contracts in order to understand whether they are receiving what they have contracted for, what savings can be found from over- or incorrect supplier charging, and what business improvements can be made to control value leakage.

A detail-based approach that considers the real operational and financial data relating to the contract can be used to identify possible savings or to assist in strengthening risk management frameworks and driving value for money. Analysis of the risks around the composition of costs, from budgeting and scoping, through monitoring, change control and validation and billing will allow a picture to be built of how the contract is operated and how commercial controls are functioning. This insight into the services and operation of the contract can also form a basis for what changes may need to be made to the scope of services or commercial arrangements, whether risk allocation or payments.

***Changing Government policies as well as affordability issues mean that departments will have different service and affordability requirements, and contracts may need to be rescoped for this new environment. In order to make significant contract savings public sector organisations will likely have to do “less for less”.***

It may be necessary to look beyond the confines of the contract in order to assess whether the services delivered are necessary in this new environment. Could specific services be candidates for reducing the scope of provision, or, in the most extreme cases, should the services be terminated? Furthermore, although some services may fall into the “nice to have” category, the volume or over-specification of other services should be assessed and challenged in order to improve value for money. A thorough understanding of service costs and drivers, as well as performance, will provide greater clarity, enabling informed contract decisions. Key questions to be asked are:

- What can be taken out or merged?
- What is the cost impact and is it value for money?
- How is the service, if required, delivered afterwards?

In addition, department procurement processes have improved by becoming more collaborative allowing for greater purchasing power. A co-ordinated approach pan-Government could further increase value for money.

Contract analysis will not only highlight what parts of the contract are not needed, it will also reveal areas that may not be working as well as they should. Contracts that have failed to deliver the desired performance will have issues over service levels and will benefit from contract review. Disagreements and disputes can be more effectively resolved when clear evidence is provided – moving the debate from the emotional to fact and data.

We recommend that changes to service scope and levels are based on accurate cost and performance information in order to capture the full potential for savings.

# Doing it differently – Contract Renegotiation

*In order to deliver the significant savings required of Government there is a fundamental need to do things differently.*

Our experience is that the commercial rationale for the contract needs to be regularly challenged. What outcomes did the contract intend to deliver and are these still valid in today's environment?

As a starting point both sides need to be absolutely clear about the outcomes needed, for how long and what the public sector can afford. Both parties to the contract will need to work together to make this happen. Restructuring the contract to allow transformational change in the way services are delivered and performance is incentivised can unlock significant savings.

Renegotiation doesn't simply mean getting the supplier to reduce its pricing but may also mean realigning risk allocation so that the contract drives the right behaviour. Looking at what does and doesn't work in a contract and then negotiating a contract that is more aligned to the services being delivered benefits both purchaser and supplier.

Successful contract review and renegotiation requires a full commercial understanding of the contract and its cost drivers. Where significant contract change is envisaged, a costed commercial option appraisal approach can help clarify the appropriate commercial route to follow. The options include:

- Using the contract “as is” – maximising any commercial flexibility levers that exist.
- Renegotiation – in all its different guises.
- Termination.

The commercial terms of the contract may allow for flexibility in terms of volume call off, periodic repricing and variation. The contract may also allow for provision of supplier cost and performance data which will aid decision making. If there is a fixed minimum demand for services in the contract it may be possible to let other public sector bodies utilise any spare capacity.

Termination of the contract can be costly and needs to be carefully weighed against the other options, especially if the services are still required.

Government departments need to also consider carefully how to maintain engagement from the incumbent supplier during a period of transition and how best to manage the move, either to a new supplier or back in-house.

Renegotiation can cover many different options: from service scope and pricing changes to re-aligning goals by altering risk allocation, incentivising efficiency and continuous improvement. The effect on the supplier must be considered so that it is able to continue to do business and deliver the services by making a reasonable return.

A detailed, case by case, approach is therefore essential to ensure that all options are considered in order to identify the optimal approach for each contract under review and, if required, to provide a platform for informed renegotiation.

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# Lessons from the private sector

The private sector is incentivised by profit, its “bottom line”, to drive innovation to do more with less and to share risks and rewards with suppliers. The public sector has a more complex set of drivers, mainly around policy and public services, and its focus isn’t predominately commercial. This lack of a commercial edge in the public sector often makes it more difficult for fresh and innovative thinking about service delivery.

However, lessons learnt from the private sector can be applied in the public sector by instilling commercial contract tension through informed contract, cost and demand management processes. Periodic checking of prices and efficiencies in the market can be used to challenge and renegotiate with suppliers. However, experience suggests that the best contracts are those where the supplier makes a fair return for the services they deliver and are incentivised to deliver those services efficiently.

Many public sector organisations are already doing these things. However, our experience from the private sector is that the following are critical factors for successful contract review and renegotiation:

- **Business ownership of the problem.** By its nature the challenge typically does not lie with procurement but with a combination of commercial, operational and financial leadership.
- **Clear executive sponsorship.** In many cases, the realisation of savings requires hard commercial choices and very careful management of delicate relationships with suppliers. Executive sponsorship which cuts across organisational boundaries is necessary.
- **Support and engagement from key business functions.** All parts of the business have a part to play in realising the savings and implementing improvements.
- **Take an end-to-end view.** It is important that all organisational functions are bought-in to the process, thus the big savings are realised through a coordinated end-to-end effort.
- **A transparent, no blame culture.** Inevitably, a review of complex contracts will uncover “mistakes” made in various parts of the organisation. Almost always this will be the result of staff making an honest effort to do the best for the department with limited information and time. Best results will arise from a culture which encourages honesty and transparency to identify and address the sources of value.

# Conclusion

The background of the page features a photograph of several hands reaching up from the bottom, holding a thin, light-colored string that forms a complex, interconnected geometric structure. The hands are positioned at various heights and angles, creating a sense of collective effort and support. The overall color palette is a mix of soft pinks, light purples, and muted blues, with a subtle gradient effect.

By their nature, savings from complex contracts are not easy to obtain. The impact of differing contractual conditions on varying parts of the business can be difficult to calculate and the dispersed nature of transactions, financial records and controls mitigates against transparency.

To achieve the ambitious targets for reducing public expenditure, every Government department will have to take a long hard look at the contracts they have today and investigate their potential for improvement. However, we recommend that all public sector bodies should regularly review their portfolio of contracts with the aim of:

- Identifying whether it would be appropriate to negotiate changes to these contracts, whether these changes are related to scope of service, allocation of commercial risk or payment terms.

- Confirming that agreed service levels are being delivered and, if not, identifying ways to correct this.
- Checking that any and all payments made and invoiced are valid under the terms of the contract and, if not, making sure they are rectified.

The balance between maintaining valuable public services and achieving cost savings will be tough to achieve. Many Government contracts are highly complex and their successful management requires an appraisal that recognises and embraces that complexity. But with an approach such as we have discussed in this Talking Points it should be possible for all departments to identify savings, address value leakage and renegotiate contracts. And this will ultimately provide benefits for service users, suppliers and taxpayers alike.

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## About PwC

PwC has been helping Government and public sector organisations locally, regionally, nationally and internationally for many years. We work with organisations across such sectors as diverse as health, education, transport, home affairs, criminal justice, local government, housing, social welfare, defence and international development. Our Government and public sector practice comprises some 1,300 people who provide a range of consulting, assurance, tax and other advisory services sharing their thinking, experience and solutions to develop fresh perspectives and practical advice for our clients and their stakeholders.

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Shona specialises in commercial arrangements between Government and the

private sector. Shona has advised Government bodies on a wide range of procurements. Shona has focused in the past 4 years in supporting Government projects with the private sector in their operational stage, enabling clients to capture value for money from their contracts. She reviews the commercial arrangements to advise clients on opportunities to reduce cost, rescope services and renegotiate terms to better align contracts with changing Government policies and needs.



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Melanie advises clients in maximising value and identifying areas for cost

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Stephen is a partner that leads our Commercial Assurance work in the public sector.

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