Oregon Sources Lemonade From Telecom Lemons

By David Yarkin

A popular saying, "When life hands you lemons, you make lemonade," relates to turning the tables on an unfavorable situation and deriving positive benefits. Sometimes, conventional solutions may not apply, and creative planning is required to "juice up" the rewards.

Through benchmarking, negotiating, and other strategies, the State of Oregon squeezed the best buy for telecommunications services

The standard strategic sourcing engagement follows a similar trajectory for both public- and private-sector organizations. As a rule, consulting firms recommend that their clients follow a tried-and-true, seven-step sourcing process, usually depicted in the ubiquitous "chevron" chart. More often than not, this process yields big dividends for state governments, with double-digit savings the norm. However, what happens when laboratory conditions do not exist? The State of Oregon confronted this challenge in June 2004.

Shortly after the administration headed by Governor Ted Kulongoski took office in 2003, Oregon decided to join a short list of state governments that were using strategic sourcing methodology to transform procurement operations.

In 2003, Oregon's state government faced a serious fiscal crisis, due to the economic recession, according to Dianne Lancaster, Chief Procurement Officer for the State. "A strategic sourcing initiative offered the promise of immediate hard-dollar savings for a government desperate to capture every dollar available to protect critical health, education, and pubic-safety services from intolerable cutbacks," she says. "Also, it just made good business sense for the state's central procurement program to move from a tactical to a strategic approach."

To guide Oregon through its strategic sourcing initiative, the State awarded a contract to Silver Oak Solutions (now CGI-Spend Management Solutions).

After about eight weeks of analyzing spend data, Silver Oak recommended that the State begin the process of sourcing ten commodities, including telecommunications.

While a number of stories have been written in recent months about strategic sourcing at the 30,000-foot level, few provide the tactics involved in sourcing a specific commodity.

"Sourcing in the States," a new series of articles written by David Yarkin, will cover strategic sourcing methodologies enacted by state and local governments. In each article, Yarkin will detail how his colleagues in other governments have generated value for their taxpayers through an individual sourcing project.

The debut article, which appeared in the December 2005 issue of *Government Procurement Journal,* focused on New Mexico's sourcing of print services. This month, "Sourcing in the States" explores Oregon's recent fact-based negotiation for telecommunications services.

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Visit: www.govpro.com to read archived "Sourcing in the States" articles or to watch an archived Webcast titled, "Transforming Procurement in Pennsylvania—Strategic Sourcing and Shared Services," which was presented by Yarkin on August 30, 2005.

Telecommunications was selected for Oregon's first wave of sourcing projects because of the significant spend amount allocated in this area. In addition, the State conducted detailed benchmarking of telecom costs. After reviewing the figures, consultants and state officials alike believed that a sourcing initiative offered the opportunity for deeper discounts than the State had seen in years.

Tactics Target Two Telecom Tiers

The State's first telecom project involved long-distance services, which through a traditional strategic sourcing approach, yielded 28 percent savings in just five months.

Oregon's second and largest telecom project involved data transport. This area covered services by which the State shares data from different end users within the State, communicates with the outside world via e-mail, and accesses the Internet.

The time was right for Oregon to negotiate a telecom deal since the State was nearing the end of a long-term contract with Qwest Communications International, Inc., a worldwide telecommunications giant. Throughout the first four years of its contract with Qwest, the State spent roughly $12 million annually. However, while benchmarking data revealed that telecom costs had decreased 7 percent annually during this time period, the State never received a cost reduction from Qwest.

"The actual cost to push zeroes and ones across the state was going down every year, but our prices were never reduced," notes Tim Walker, State Procurement Analyst with Oregon's Department of Administrative Services (DAS).

While the traditional sourcing strategy involves developing a detailed accounting of requirements, writing and publishing an RFP (Request for Proposal), and negotiating with a handful of finalists, Oregon decided to take an innovative approach that ensured maximum savings.

Elected in 2003, Oregon Governor Ted Kulongoski was instrumental in advancing the state's strategic sourcing initiative for telecommunications services.

Oregon officials believed that Qwest was the only supplier that had a reasonable chance of responding to an RFP covering all of the required data transport services. Just as importantly, officials recognized that Qwest also realized this situation and that the firm's proposal would reflect the lack of competition in the market.

"The telecom market in Oregon is very different than on the East Coast," Walker explains. "The infrastructure required and the lack of population density creates a high barrier to entry. We were faced with a player that had 75 percent of the frame-relay data access market and resold the other 25 percent."

Oregon began a fact-based negotiation (FBN) with Qwest in June 2005, within the State's offices located in Salem. A multi-agency strategic sourcing team, led by Walker, spearheaded the process.

The negotiating appeal was twofold. The State presented Qwest with benchmarking data showing the 7 percent year-on-year decrease in cost, followed by asking Qwest to align its pricing based on the market data. Recognizing that the State had contractual commitments to Qwest, officials asked for an immediate rate reduction in exchange for other sources of value that Qwest and the project team might identify together.

Six weeks later, Qwest delivered its response, offering a rate reduction of less than 1 percent.

Rob Lightfoot, CGI's project leader in Oregon, provides insights into Qwest's likely strategy: "When vendors believe that multiple rounds of negotiation are possible, they may offer the smallest discount possible at first, with the expectation that they will need to lower prices again."

Immediately after receiving Qwest's rate reduction, Oregon's strategic sourcing team deemed the price concession "unacceptable" and retreated to plot its negotiating strategy with Qwest. After analyzing various factors, the team decided to change tactics.

"We repackaged our approach," Walker says. "We wanted to get our point across on why it was important for [Qwest] to get more aggressive with its discount structure. Instead of approaching Qwest around the logic of costs, we talked about the financial difficulties the State was facing and why we needed savings in this particular area."

Walker adds, "The State was going to cut costs in data transport with Qwest's help or without it, through cutting services if it had to, though the preference was to find ways for providing value to both parties."

Eight weeks later, Qwest responded to the State's negotiating strategy by submitting its second price concession, but one that still only delivered about 1.5 percent total savings. Like Qwest's first offer, Oregon officials rejected the second price proposal.

Inviting Competition

After appealing to Qwest on logical grounds and, more broadly, in the name of the relationship the State had maintained with Qwest, Oregon officials felt they had hit a roadblock and changed course by 180 degrees. Walker and his team ended their formal negotiations with Qwest and began developing an RFP for data transport services.

In formulating the RFP, a first step was to begin the process of expanding the market by increasing competition. Despite Qwest's inherent advantages, Oregon began reaching out to its competitors in order to build a supply base that could respond to the RFP.

Oregon's efforts focused on two telecom giants—SBC and Verizon—both of which possessed the financial wherewithal to overcome Qwest's strong market position.

Two months after Oregon's discussions with SBC and Verizon began, Qwest approached Walker with a request for another negotiating session. The firm offered a 15 percent discount, in return for a two-year extension of the contract.

The strategic sourcing team felt that a two-year extension would not be politically viable, since Walker's team had just recently extended an olive branch to SBC and Verizon. In addition, there was not a contract mechanism for an extension of that duration.

Ultimately, Qwest agreed to a 10 percent discount, with a one-year contract extension. These terms equated to $1.8 million in biennium savings during the specified time period.

Despite being all but rebuffed in two previous negotiations with Qwest, Oregon's sourcing team succeeded in negotiating substantial rate reductions. The parties had not changed, nor had the competitive market. What factors changed during that period to bring Qwest to the bargaining table? Two reasons had advanced the strategy: Oregon's remaining commitments on the Qwest contract had declined significantly, and the State was ready to re-procure the existing contract in the marketplace. However, Walker credits relationship management as the decisive factor for successful negotiations.

Tim Walker, Oregon State Procurement Analyst, headed a strategic sourcing team for negotiating a telecom contract.

Communicating and Creating Credibility

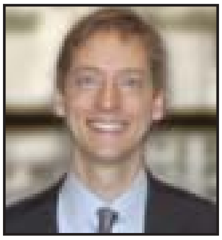
Although formal negotiations with Qwest broke down not once, but twice, Oregon's sourcing team kept an open line of communication with Qwest executives. Walker maintained regular, informal communications with Qwest's Greg Schwartz during the process. This ongoing relationship gave Qwest a sense that the overture ultimately made by the firm would be well received by Oregon officials. The State also ensured that it conveyed a unified voice by maintaining stronger communications within all levels of the government where Qwest had developed deep relationships.

Schwartz commends Walker for maintaining open lines of communication: "Tim is a very good communicator, very accessible, and he understood both the bureaucracy and the business side of the process," he remarks. "It was Tim's ability to bridge the two worlds between the vendor and the State that helped make this negotiation successful."

Just as importantly, negotiators from Oregon moved light years ahead in establishing credibility with Qwest's negotiating team. At the outset of the first negotiation, Walker and his strategic sourcing team had two obstacles to overcome. First, the team from the State Procurement Office was a newcomer to the telecom bargaining table.

"[Qwest executives] were used to negotiating with technology people who were focused on issues like new technology, service levels, and providing users with access to data and technology resources," Walker notes. "It's not that we aren't concerned with these issues, but we are also concerned with price points and data. All of a sudden, they had the State procurement people asking for price reductions. It was a different type of conversation than they were used to having with the State."

Schwartz agrees, "The State



Rob Lightfoot, CGI Project Leader, helped guide the State of Oregon through its strategic sourcing initiative.

Procurement Office had to come up to speed from a technical perspective, while Qwest had to come up to speed from a procurement perspective. We generally dealt with the technical people. Now, procurement was leading it and had different priorities, so bridging that took a little bit of time."

Second, Oregon officials believed that given Qwest's infrastructure, clout, and relationships within the state government and its existing contract, the firm did not believe that there was a credible threat to losing the state's business until the contract was nearing its natural end. The likelihood of a significant price concession was therefore nil, because there was no compelling reason for Qwest to offer substantial savings to the State.

However, when Qwest officials became aware that an RFP was in development, the message was clear that DAS had support from both the executive suite and from the technical operations staff to seek out the best deal. Facing a credible threat to their business with the State, Qwest stepped up their negotiations and revised their offers accordingly.

Optimizing End Results

Integrated strategies contributed to Oregon's successful negotiation for telecommunications services. "During the course of the negotiations, relative leverage changed for a number of reasons: Oregon had obtained market knowledge through traditional benchmarking efforts. It had prepared itself to go out for a solicitation sooner than Qwest had imagined, and the backlog of contractual commitments had diminished," CGI's Lightfoot emphasizes. "Because the fundamental economics made sense for both parties, a renegotiation was going to be successful."

Lightfoot believes that the environment is conducive for a successful FBN when the following five factors exist:

1) When the scope of the negotiation is within the scope of the original RFP.

2) When both parties have legitimate value to gain.

3) When there is an important incumbent supplier relationship.

4) When both parties face significant switching costs.

5) When there is cohesion between the various stakeholders within the government.

Thanks to fundamentally sound procurement strategies, which were well executed by Oregon's sourcing team, the state's taxpayers benefited from meaningful savings, and a win-win situation resulted for both the State and its telecom supplier, Qwest.

In all, Oregon saved more than $14 million across all of its telecommunication sourcing projects. As governors from both political parties and more than a dozen states have accomplished over the past three years, Governor Kulongoski was able to drive scarce resources away from the cost of buying goods and services to programs that enhance the lives of citizens.

Substantial savings resulted from a strategic sourcing initiative, within a telecommunications category where the deck appeared to be stacked squarely against the state's procurement team. ❒

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