Welcome and Introductions

- Workshop structure, breaks, lunch, questions, handouts, web site
- Takeaways – Capture ideas & make use of them
- Collaborative process of exploration and sharing
- Introductions
  - company, career, expertise, interests
- Discussion; Collected Expertise –
  - what can we share today?

Learning Objectives

- Fair & reasonable pricing
  - What’s the difference?
  - Analyzing proposals
  - Price analysis vs. cost analysis
- Direct & indirect costs
  - What’s the difference?
  - How costs affect the selling price
- How cost & price information can be used to negotiate better contracts
Agenda
Where do we want to allocate our time?
- Fair & reasonable pricing
- Price analysis
- Direct costs
- Learning curve
- Indirect costs
- Profit & fee
- Negotiation strategies and tactics related to cost
- Questions and discussion

Fair & Reasonable Pricing

Why Analyze Proposals?
- Control costs
- Business reality
- Sarbanes-Oxley Act (SOX) audit & due diligence responsibilities
  - How could a seller have significantly lower mfg costs than competitors? (illegal trade or worse)
- Government audits
- Renegotiation & reorder
- Cancellation & termination
Manipulating Prices  - Sellers

- Quantity & trade discounts
- Special deals, closeout sales
- Loss leaders
- Parametric pricing
- Bulk pricing
- Distributor discounts
- How can we protect ourselves from price manipulation tactics?

Manipulating Prices  - Buyers

- Timing purchases
- Blanket purchase agreements
- Long term agreements
- Consolidated purchasing agreements
- Determine what the price “should be”
- Bundle items
- Negotiate more complete & better agreements

Supplier Pricing Models

- Cover fixed & indirect costs or......
- Market Based - Profit as a business strategy
  - Selling at a loss until production volume reduces cost to profitability
- Market Share
  - Win the business – then raise the price
- Competition – the going rate
- Buyer’s power in the market
- Move inventory

Negotiation tip: Remove the market influence. Make the transaction confidential.
Price Analysis

Would a prudent person pay this price?

- Is this a reasonable price?
  - Based on the perceived value of the product
  - In this economy under these conditions
- Is this the best price or the right price?
  - Too good to be true – usually isn’t
- Are prices changing over time?
- Are the variables reasonable?
  - Should I have gotten a discount?
  - What adders will we have to pay?

Price Analysis Tools

How do I get the right price?

- Market price; use effective competition
  - RFQ vs. RFP vs. Bid vs. reverse auction
- Catalog; comparison shop published prices
- Govt. indices & reports; e.g. Dept. of Labor, Dept. of Commerce (DOL, DOC)
- Regulated pricing
- Published industry metrics
- Price-related evaluation factors
  - Direct costs not included in the contract price
- Total Cost of Ownership/Total Cost of Acquisition (TCO/TCA)
  - Acquisition costs

Google: "price index"
Is The Price Fair?

Can a reasonable price be unfair?

- Seller leveraged to sell below cost
  - only 1 buyer, unfair competition,
- Buyer locked in with no alternative
  - Noncompetitive, tight spec., unique product
- Why care about fairness?
  - Performance, repeat business,

An effective, well-formed contract includes prices that are reasonable based on current market conditions and fair to both the Buyer and Seller

Noncompetitive

Strategies for pushing back in noncompetitive situations

- Independently verify a fair price
  - Then stop whining or start doing some homework
- Win-Win negotiation
  - Establish a relationship and help the supplier understand the value of a fair contract
  - Help the supplier reduce cost
- Leverage buyer decisions
  - Long term agreement, different terms, order dates
- Publish requirement
  - Invite competition
- Raise visibility of the business impact and cost internally

Factors Influencing Selling Price

- Setting the selling price is a business strategy
- Opportunities for improvement hide in the overlapping spaces
Cost Vs. Price

The total cost of the transaction is not the price

- Acquisition (TCA) & Ownership (TCO) costs “buyer’s commitment to the deal”
  - Costs to issue the contract, use and replace the product
- Cost of Sales (COS) “seller’s investment in the deal”
  - Marketing, customer service, rework, business operations
- Actual cost to produce the product or service
  - Materials, labor, packaging,
- Price is arbitrary and can be negotiated
- Costs must be mitigated or avoided

Why Cost Analysis?

I'm not a government contractor, why should I care about cost analysis?

- Changes which can increase /decrease a supplier’s cost and affect Buyer’s TCA/TCO
- Cost escalation which is not correctly applied to the price
- Post award changes
  - Rejections
  - Partial cancellations
  - Spare parts
  - Reorders, outages
  - Follow-on orders

Negotiation Strategy

How can cost analysis be used to reduce the price?

Evaluate the total transaction costs (for both buyer and seller)

Negotiate the lowest total cost (price plus TCA, TCO, COS, etc.)
Seller’s Direct vs. Indirect Costs

All costs are not equal

- **Direct costs**
  - Materials, components and the labor to make the item
  - Workers swinging a hammer or moving dirt
  - Variable e.g. 1 item = 1 set of direct materials + labor

- **Indirect costs**
  - Elements of the process allocated to many different parts (e.g. QA)
  - Costs involved with operating the business (e.g. accounting dept.)
  - Fixed – we have to sell enough parts to pay for operating the plant

- **Break even analysis to set price**

  Fixed Costs
  \[ \text{price} - \text{variable costs} \]

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Contract Pricing Model

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Direct Costs

Cost which can be directly attributed to the end objective
Direct Materials

What can a buyer do to affect direct material costs?

- Are direct materials a large percentage of the total cost of the item or service?
  - If so, then this is a big target for cost savings
- Substitute raw materials, negotiate strategic supplies, change the specification, eliminate components, reduce waste, reduce defects
- Negotiate strategic contracts that better utilize production processes, more efficiently amortize special tooling and reduce supplier inventory costs

What can a buyer do to influence the cost impact of direct materials?

Negotiation Tip:
The best time to negotiate the price of this spare part is when you buy the product.

Some direct materials can/should also be spare parts.
E.g. cutter teeth

Why is it always at the top?
Direct Labor Issues

What concerns should we have about direct labor

- Labor to build, fabricate, assemble, ship and service
- Labor as a large part of total cost or unique skills
  - Opportunities and dangers are huge
- Labor problems
  - Specialized workers could leave or retire
  - Union agreements could expire
  - Social responsibility issues
- Labor Opportunities
  - Automation
  - Learning curve, efficiency, setup time
  - Supervision, training, safety, social responsibility

Manipulating Direct Costs

Other relationships between direct costs and prices

- Product is more valuable to the buyer than it is to the seller
  - Seller set prices below his material costs
  - Seller uses buyer as a shill
- Residual value - beneficial reuse
- Trade discounts
- Consolidated purchasing agreements
Evaluate tooling, molds, jigs & special worker training

Rarely is there only one buyer

Learning Curve (LC) Presentation
Learning curve principles can apply to a product or service, they can affect the whole process or specific pieces of the process (at different rates) and LC principles can be observed when looking at an organization or company performance.

How long does it take to get fast at this job?
**Learning Curve Takeaway**

- Learning curve will be steeper for manual repetitive tasks
- Stopping work will interrupt the curve
- There can be different LCs for separate parts of the process
- Production time declines with each double in qty.

http://cost.jsc.nasa.gov/learn.html
http://maaw.info/LearningCurveSummary.htm

**Indirect Costs**

- Material acquisition storage & handling
- Labor overhead
  - Fringe benefits, supervision
  - Fully burdened labor rate
- Support organizations;
  - Accounting & purchasing
- General and administrative costs
  - Electricity, insurance, executives

**Direct Cost Allocation**
Indirect Cost Pools

- Grouping indirect costs to simplify accounting
- Allocate proportionally to unique cost objectives
- Multiple pools vs. single pool – who decides?
  - Reduces overall risk to the contractor
  - Could increase cost to unique objective
- Indirect cost pools represent contractor business processes you may not be aware of

Negotiation tips:
- Check allocation
- Use the services you are paying for

Indirect Cost Concerns

What should I look for when reviewing indirect cost elements?

- Cross charging: workers who charge time directly to the project cost and also are included in a cost pool?
- System to correctly accumulate, report and allocate costs
- Duplicate and overlapping cost pools
- Cost adjustments and out-of-date rate calculations
- Unallowable expenses in indirect cost pools

Discussion: Why contractors manipulate indirect cost pools

- Moving costs from direct-charge to a cost pool to change the competitiveness of a quotation. Example: Boeing Aircraft with a large expenses material acquisition cost – trying to sell engineering services

What should I look for when reviewing indirect cost elements?

Contract Cost Buildup

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct material</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Material handling 10%</td>
<td>4,000</td>
</tr>
<tr>
<td>Direct engineering labor</td>
<td>6,000</td>
</tr>
<tr>
<td>Engineering overhead 100%</td>
<td>6,000</td>
</tr>
<tr>
<td>Direct manufacturing labor</td>
<td>12,000</td>
</tr>
<tr>
<td>Manufacturing overhead 100%</td>
<td>18,000</td>
</tr>
<tr>
<td>Other direct costs</td>
<td>6,000</td>
</tr>
<tr>
<td>Subtotal</td>
<td>$92,000</td>
</tr>
<tr>
<td>General and administrative 25%</td>
<td>23,000</td>
</tr>
<tr>
<td>Total cost</td>
<td>115,000</td>
</tr>
<tr>
<td>Profit 15%</td>
<td>17,250</td>
</tr>
<tr>
<td>Cost of money for facilities capital</td>
<td>1,500</td>
</tr>
<tr>
<td>Price</td>
<td>$133,750</td>
</tr>
</tbody>
</table>
Appropriate Costs

Which costs will I accept in a proposal?

- **Reasonable**: "Would a reasonable person pay this?"
- **Allowable**: "Did I agree to pay for that?"
- **Allocable**: "Does this cost belong to a different job?"
- **Fair cost estimate**: "Independent comparison"
- **Should cost estimate**: "Based on best practice"
- **Cost realism**: "Does the proposed cost reflect a realistic understanding of the requirements?"
Profit & Fee

How much profit is reasonable?
When / how does the contractor earn profit?
When / how does the contractor lose profit?
Weighted Guidelines templates
Profit or Fee
Do contractors have to make a profit?

- Fixed fee, incentive fee, award fee
- Fee as a motivator
- Fee sharing arrangements
- Why is cost + fee a bad idea?
- How much is reasonable?
  - Industry average
  - Weighted Guidelines
  - Enough to get the job done right

Weighted Guidelines –
1. Split the costs into separate elements
2. Allocate a profit based on the cost risk to the contractor for that cost element
3. Assign weights to each based on the nature of this transaction
4. Do the math

Analyzing Profit

- Weighted Guidelines – Dept. of Energy (DOE) Guide for determining appropriate contractor fee
  energy.gov/sites/prod/files/15.4-2_Weighted_Guidelines_0.pdf
- Weighted Guidelines Form – Dept. of Defense (DOD)
- DOD guide to analyzing profit or fee
Negotiation Targets

- Direct Costs
- Indirect Costs
- Profit
  - Retail Price
  - Negotiated Price
  - Unearned Profit

Contract Types

- FFP
  - FFP
  - T&M
  - CPFF
- Cost
  - Incentive
  - Award
  - Share

Cost Estimating Web Site

http://cost.jsc.nasa.gov/push.html

(c) ML Taylor 2012
Cost-related Concepts

Seller Accounting Systems
What do buyers want to know? & why?
- Disclosure statements; accuracy vs. fluff
- Cost Controls & adjustments
- Financial controls audit
- SOX & Management Accountability
- GAAP and CAS compliance
  (Generally Accepted Accounting Principles, Cost Accounting Standards)
- Supporting documentation & records
- Tax liabilities & liens
- Incurred vs. estimated costs
- Adequacy determination
- Electronic records

Rate changes over the life of a Contract
Cost Principles Review

Seller’s costs and how they affect the selling price.

- What are direct costs?
- What are indirect costs?
- What are cost pools and how do they work?
- What is learning curve?
- How do fee & profit get included in a selling price?
- How does a buyer’s specification affect the selling price?

The Fed

- FAR
  - 30 (CAS)
  - 31 (Cost Principles)
  - 32 (Financing)
- Responsible supplier
- Buyer determinations
- Fact finding
- TINA
  (Truth in Negotiations Act)
- Certified Cost & Pricing Data
- Allocable, allowable and reasonable costs
- Financial system adequacy
- CAS
- Accounting system disclosure statement
- Incurred cost audit
- DCAA, GAO, IG
- ASPM
  Armed Services Pricing Manual

Vocabulary review

The language of cost-price analysis

- Accounting Period
- Allocable costs
- Allowable costs
- Average costs & Standard costs
- Break Even Point
- Capital costs
- Carrying costs
- Cost Accounting Standards
- Cost of Money
- Cost Pool
- Direct costs
- Direct labor
- FASB
  Federal Accounting Standards Board
- Fixed costs
- Fringe benefits
- Fully Burdened Labor Rate
- GAAP
- Incremental costs
- Indirect costs
- Inventory costs (LIFO/FIFO/Weighted Avg)
- Job costing analysis
- Learning curve
- Life cycle & economic life cycle
- Not to exceed costs
- OECDs (Other Direct Costs)
- Overhead
- Parametric pricing using Cost Estimating Relationships (CERs) to price an object.
- Profit/Fee
- Recurring and non recurring costs
- Standard Costs
- Total Cost of Acquisition/Ownership TCA & TCO
- Variable costs
### Negotiating Costs

**Strategies related to costs**
- Ordering a glass of milk as a separate item or getting the milk as extra raw materials
- Paint as a left over or paint as a separate purchase?
- Spare parts & operating supplies as part of the initial purchase agreement
- Strategy to reduce selling price by reducing seller’s costs or pricing drivers
- Strategy to reduce buyer’s acquisition cost

### Discussion Topics
- The power of a solicitation
- Fact finding
- Buyer-provided materials / services
- Post award scope changes & impact on price
- Negotiation tips

### Cost & Negotiation Opportunities

<table>
<thead>
<tr>
<th>Item</th>
<th>Direct</th>
<th>Indirect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Office Furniture</td>
<td></td>
<td></td>
</tr>
<tr>
<td>HVAC Upgrade</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shipping Boxes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Painting service</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Advertising</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Software</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fabricated assembly</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
RFP Development

I need more than just a price.....

- What cost information can I ask for?
- What information do we want with the proposal?
- What do we want to know about subcontractors?
- What administrative controls do we want?
- SOX and buyer's due diligence
  - E.g. how could a seller have significantly lower mfg costs than competitors (think 3rd world)
- Other govt.-related risks to avoid
  - Liens, taxes, fines,
  - How can I find solicitation examples?

Fact Finding

THE most important lesson I've learned in govt. contracting!

- Don't assume anything. Verify everything.
- Do I have to buy materials in standard quantities?
- Scrap value. Does the left-over or waste material have a residual value?
- What is the optimum labor mix?
- What are the critical-path cost elements?
  - Strategic Materials, Labor agreements, price volatility
  - Make or buy options?
  - Commodity pricing and hedging
  - Subcontracting risks
- What are the recurring vs. one-time costs?
  - Why is the price set at this level?

Buyer Provided Materials/Services

Is there some part of this agreement I should self-perform?

- Buyer provided services (GFE / GFS) What do I have the expertise or capability of furnishing/performing more cost effectively than the seller does?
- How could a customer get a better price on raw materials than a manufacturer?
  - The green stuff – MolyD grease or food grade grease – which is a special order and way more than the contractor needs for my job.
- Assist a supplier in obtaining products or services where I have more leverage
  - Steel for which I have an allocation but the fabricator does not
  - Special tools which the supplier’s work team can use to do the job in my facility.
- Self-perform part of the service that I can do less expensively
  - Backhaul from M&I & bulk chemical
  - NDE inspector which I have on staff
Is Price Analysis Enough?

- Competitive proposals established a competitive range.
- Market is free and open.
- Price seems reasonable.
- Is it a fair price?
- Is it the right price?

Is Cost Analysis Enough?

- I can prove the contractor is charging a fair price.
- Actual cost plus a reasonable markup.
- Has good cost controls in place.
- Has good accounting system.
- But is it reasonable?
- Is it the right price?

Value - ROI

- Alternative to decreasing cost is to increase the value.
  - (cereal box with 25% more)
- Red carpet service.
- Indirect benefits - overlooked.
- Scrap and by-product sales.
- Social or Marketing Value.
Negotiation Strategies Related to Cost & Price
(Separate Outline & PowerPoint)

BATNA – there are times when the price isn’t fair or reasonable – but you have to do something.

References

- HUD cost/price Q&A
  - www.hud.gov/offices/cpo/grantees/cstprice.cfm
- Federal Acquisition Regulation
  - www.arnet.gov/far/index.html
- Parametric Cost Estimating Handbook
  - www1.jsc.nasa.gov/bu2/PCEHHTML/pceh.htm
- Society of Cost Estimating and Analysis
  - www.sceaonline.org/
- Microeconomics vs. Macroeconomics
  - www.tutor2u.net/economics/presentations.html
- DCAA Audit Manual
  - www.dcaa.mil/
- CAS Standards
  - www.access.gpo.gov/
- Society of Cost Estimating
  - www.sceaonline.org/
- Defense Acquisition University
  - www.dau.mil/
- OMB Circular A-76 – Commercial Activities
- OMB A-123 – Mgmt accountability (SOX)
What’s it Worth

Negotiation Leverage Strategy

➢ A product or service is usually not valued the same way to a buyer as it is to the seller
➢ Understanding which and why is key to developing a winning negotiation position