Federal CFO: Leveraging Flexible Pricing Strategies in Working Capital Funds (WCF)

An opportunity to improve capital management and optimize the alignment of resources to mission needs

Dynamic pricing is emerging as a leading pricing strategy used by companies across business-to-consumer and business-to-business sectors to capture the most value for their products and services. This pricing strategy involves changing prices, often in real time, in response to changes in supply and demand. It is challenging the way of doing business for companies that have long conformed to fixed prices.

The transition to dynamic pricing has become inevitable in many of today's commercial sectors where, now more than ever, customers are gaining access to price and competitor information where and when they want to through online sources and mobile technology. Airlines and hotels are evident examples of companies that have used dynamic pricing models on their websites for years. A seasoned traveler will tell you that finding bargains for airfare and accommodations will vary on a number of demand factors that impact price, including the day and time of purchase and the range of dates considered.

Dynamic pricing is spreading beyond online outlets and breaking into physical environments and more conventional businesses. The Indianapolis Zoo, for instance, recently implemented dynamic pricing leading to a revenue increase of 12% in 2015[1]. Rather than charging a fixed price of $16.95, the Zoo charges anywhere between $8 and $30 for an adult pass. The price changes are based on advanced sales and expected demand, which help the Zoo attain an optimal price to maximize its sales and profit potential.

Considering its widespread adoption in the commercial sector, does dynamic pricing have a place in a federal environment? While federal agencies do not share the same profit driven incentives, the principle of dynamic pricing has potential to improve capital management, particularly for government programs operating under a Working Capital Fund (WCF) where a buyer/seller relationship exists. In a WCF environment, customers and market factors play important roles in driving the price setting process, and a more flexible pricing model can lead to improvements in capital management.

In many cases, WCFs rely on fixed prices and overly simplistic, sometimes antiquated pricing models confined to prices set months or even years ahead of execution. This exposes the WCF to fluctuations in cost / demand during execution resulting in either large cash deficits or surpluses for the fund and managing organization. The latter is more often true, where WCFs have mitigated the risk of fluctuations by building generous budget contingencies into their pricing models that result in inflated prices and large cash surpluses in an effort to avoid ending the fiscal year with a deficit.

In the past 15 years, several WCF investigations led by the Government Accountability Office (GAO)[2] involved poor capital management involving large cash surpluses and balances. This is evidence of a common problem for many WCFs needing a more flexible approach to demand projection and price setting. For Federal CFOs, dynamic pricing for a WCF may be unrealistic, but the introduction of more flexible pricing strategies may be an attractive option for discretionary products and services of mature WCFs. A flexible pricing strategy can help Federal CFOs reduce the impact of changes in costs or demand, and derive an optimal price for their services. This has the potential to improve capital management by reducing the risk of large cash surpluses or deficits, and contribute to the underlying objective of WCFs: optimize the alignment of resources to support mission needs.

Benefits of Flexible Pricing in WCFs

Flexible pricing strategies can serve as powerful catalysts to drive value for Federal WCFs, their customers, and the organizations they support. By leveraging information on cost drivers, consumption patterns, customer preferences, and organizational goals, flexible pricing brings three major benefits to help Federal CFOs improve capital management for the organization. These should be evaluated as a net benefit to the whole organization, comprised of both the WCF and offices directly involved in advancing the agency mission. Changes should seek to improve capital management for the whole organization without transferring risk to customers (e.g. appropriated offices) that do not enjoy the funding flexibility of WCFs.

Flexible pricing can normalize demand for discretionary products and services

Throughout a fiscal year, a WCF is often faced with changes in customer consumption and demand patterns. Common evidence is the hike in demand from appropriated customers in the final weeks of a fiscal year as they seek to obligate single year appropriations and exhaust budget capacity. This pattern

[1] http://www.wsj.com/articles/now-prices-can-change-from-minute-to-minute-1450057990
[2] http://gao.gov/search?q=working+capital+fund&Submit=Search&page_name=main&path=Reports+%26+Testimonies%3AReport

complicates resource management throughout the early parts of a fiscal year where WCFs may have excess capacity, and puts stress on the fund at year-end where its capacity is stretched or exhausted. By offering price related incentives at the beginning of the year, a fund can motivate customers to spend discretionary funds earlier and allocate spending more evenly throughout the year. For example, training services can be offered to customers at a discount during the initial months of a fiscal year or to request additional capacity (e.g. reimbursable authority) to manage demand when capacity is worn thin at year end. The result is a more normalized demand and revenue stream, and more manageable capacity for the fund.

Flexible pricing can reduce the risk of change in operating costs and returning large unanticipated profits or losses

In some WCFs, price setting for good and services occurs in concert with annual budget formulation exercises where prices are fixed throughout the year of execution in accordance with the Agency's policies or authorizing legislation. The methodology may vary but, in its most basic form, fixed prices are based on an analysis of prior year costs plus expected investments or capital outlays. While simple in its execution, this strategy makes WCFs vulnerable to changes in both costs and demand as a result of outdated projections or market fluctuations.

Managing the impact of market fluctuations on WCF prices is a pertinent issue that the Department of Defense (DOD) has faced for years, specifically for its bulk fuel program. Under this program, the DOD purchases fuel in bulk to resell to its military units and other customers. It sets prices a year in advance for budgeting purposes, and incurs the actual cost of the fuel upon purchase. The impact, according to an investigation conducted by the GAO in 2014, is a difference on average of more than 70 percent between estimated and actual costs[3].

In this example, the DOD sets prices by factoring economic assumptions, refinement markups, overhead costs, and cost recovery adjustments. While the fund is inherently intended to offset risk of price fluctuations away from its appropriated counterparts, there may be opportunities to introduce pricing flexibility with the aim of improving capital management for both the fund and the affected Defense agencies. This of course assumes that any changes in price are supported by a change in DOD policies and remain within the limits set forth in baseline estimates of the Defense budget, as prescribed by OMB Circular A-11.

The same logic applies to WCFs involved in the sale or purchase of goods and services outsourced to third party vendors, as well as WCFs susceptible to regular changes in their portfolio of product and service offerings.

Flexible pricing can optimize the alignment of resource to mission needs

Using flexible pricing, WCFs can influence demand and reduce the impact of changes in operating costs thereby improving the fidelity of their projections and ability to meet financial metrics. Using a broader lens, flexible pricing promotes a transparent and agile business enterprise and increases the need for reliable and dependable customer service from a billing standpoint. It prioritizes regular analyses of cost and demand factors, and promotes fiscal transparency for customers. This is especially relevant to a recent GAO investigation on the Department of Justice (DOJ) WCF where investigators found that customers did not receive sufficient information on rates and billing processes, which was provided via an annual customer advisory board meeting. Because rates are generally fixed, there is little incentive for customers and service providers to engage on a more continuous basis, increase cost transparency, and improve accountability for the organization.

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[3] "Bulk Fuel Pricing: DOD Needs to Reevaluate Its Approach to Better Manage the Effect of Market Fluctuations." *U.S. GAO*. 8 July 2014. Web. 10 Feb. 2016. <http://www.gao.gov/products/GAO-14-595>.

A model that allows for flexible pricing can foster a more intimate customer relationship that openly coordinates on refining pricing assumptions and accounting for changes in the market with the aim of improving capital management for the organization. This puts onus on the customers to improve their management of funds and not solely rely on the WCF to absorb the risk of cost fluctuations or poor investment planning.

Additionally, many WCFs have policies for refunds or reallocations to customers upon finding budget surpluses at year-end, resulting in customers having little to no time to use these returns if they are confined to single year appropriations. While well-intended, refunds to customers can backfire by hurting the fund's credibility in accurately pricing its goods and services; flexible pricing can reduce situations where WCFs are cornered into such situations.

While flexible pricing can benefit an organization, it is important to consider its implications in execution, particularly from an audit and risk management perspective. Flexible pricing in WCFs must abide by requirements set forth in its authorizing legislation and, per OMB Circular A-11, the net impact of changes in price must ultimately seek to be consistent with baseline estimates set forth in the budget. It also assumes WCFs are able to justify and substantiate changes in price with readily available data that can be shared with customers via well-established communication channels, and that ultimately seek to rectify outdated assumptions and drive towards a net benefit for the whole organization.

Imperatives for using Flexible Pricing in WCFs

First and foremost, flexible pricing works best when applied to WCFs for discretionary products or services where customers have purchasing power, as opposed to being confined to a tax with limited flexibility to opt in or out of services. This implies that the products or services can be procured externally from the WCF, such as support for dedicated trainings, application development and enhancement, and project management services among others. Understanding this fundamental distinction, flexible pricing is poised for success in mature WCFs that encourage the following imperatives:

Success imperative #1: Comparative net cost impact to the organization to guide flexible pricing

Adopting a flexible pricing model is contingent on the organization having an advanced understanding of its fixed and variable costs, and the net impact of changing prices for the WCF and its customers. Changes in price should aim to improve capital management for the whole organization and avoid making pricing decisions solely for the benefit of the WCF.

Success imperative #2: Advanced data analytics to substantiate flexible pricing

Flexible pricing requires advanced analytics to evaluate data associated with demand and costs, and ultimately justify changes in price to customers and stakeholders. Depending on the type of products and services, data analytics should cover a wide spectrum of internal and external cost and demand factors measuring current assumptions against historical trends and projections. This means combining quantitative and qualitative analysis to arrive at conclusions that supersede previous working assumptions. Depending on the desired level of sophistication, the analysis can be achieved through a fund's existing analytical capabilities or an investment in pricing optimization software products.

Additionally, the success of flexible pricing will depend largely on the integrity of the data used to substantiate changes in price. The level of data integrity in a WCF can be evaluated among three global dimensions evolving around its availability, consistency, and controls:

- Availability – Is the data retrievable by WCF staff and business units, and can the data be used to substantiate changes in price to customers?
- Consistency – Can the data be retrieved on a consistent basis across fiscal years and business units?
- Controls – Can the data sources be validated and are controls in place to minimize data discrepancies?

A less than confident affirmative response to these global dimensions implies a WCF may need to optimize its data infrastructure through integration of its business and IT functions, clearly defined processes to validate data universes and business rules, and a more agile IT function to retrieve data and work with business units to improve data integrity.

Success imperative #3: Mature and transparent relationships with stakeholders to support flexible pricing

As it should, changing prices will raise questions from customers and will have an impact on their perception of the fund. Whether the impact is positive or negative depends largely on the success of the WCF's implementation of flexible pricing, to include establishment of a culture of transparency and open communication with customers so they understand and can appropriately plan for changes in price.

This can be achieved by making price information available on-demand and establishing a structure to justify price increases or decreases via well-established internal and external communication channels. Investments in internal organizational development and external stakeholder outreach (e.g., customer service training, online price catalogs) will lay the groundwork to successfully implementing flexible pricing in a way that is perceived as mutually beneficial and equitable to both the WCF and its mission customers.

In addition to liaising with customers of the fund, the success of flexible pricing is dependent on gaining support from stakeholder groups responsible for overseeing the fund, including the Agency or Department senior leadership, OMB, and Congress. Early and frequent conversations with these stakeholders will help address policies or legislative restrictions imposed to a WCF that may impact a flexible pricing strategy, and provide an avenue to discuss how the WCF is using flexible prices to achieve better value for its business units and customers.

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