AVASCENT SERIES ON AFFORDABILITY AND INNOVATION: *HELPING THE DOD SOLVE ITS AFFORDABILITY CHALLENGE*

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The Department of Defense (DoD) is facing a monumental challenge. After a decade of dramatic growth, the Department has entered a new era marked by declining budgets and continuing missions abroad. Congress has asked DoD to remain capable of addressing a range of threats, while at the same time significantly reducing its top-line expenditures. This challenge has contributed to DoD increasing its emphasis on program affordability; a concept outlined in former Under Secretary of Defense for Acquisition, Technology, and Logistics (USD/AT&L) Ashton Carter's 2010 memo on Better Buying Power (BBP)[1], which is due to be formally updated in January 2013 in the form of current USD/AT&L Frank Kendall's BBP 2.0.[2]

While some of BBP's initiatives have yielded measurable results in the last two years, the scope and criticality of the current challenge invites a different look at DoD's approach to affordability altogether.

While the Better Buying Power initiatives are well-intentioned, most are likely to produce only modest cost savings that will do little to address the sheer magnitude of DoD's affordability challenge.

THE CURRENT DOD CUSTOMER APPROACH TO AFFORDABILITY

As a result of BBP, DoD customers are increasingly asking contractors to cut costs in order to make platforms and services more affordable. Avascent has observed that customers expend a great amount of time and resources scrutinizing contractors' component-level material costs, overhead rates, and production labor costs to find savings. Contractors are also being pressed to absorb many of the research and development costs previously reimbursed by the customer or to meet requirements using commercial off-the-shelf (COTS) products and solutions. The implicit assumption in these cases is that contractors should be able to find significant savings within their current cost structure. In fact, that is a key tenet of BBP's "Should Cost" management construct.

[1] Carter, Ashton B. "Better Buying Power: Guidance for Obtaining Greater Efficiency and Productivity in Defense Spending," Memorandum for Acquisition Professionals, September 14, 2010

[2] Kendall, Frank. "Better Buying Power 2.0: Continuing the Pursuit for Greater Efficiency and Productivity in Defense Spending," Memorandum for Defense Acquisition Workforce, November 13, 2012

BBP's Should Cost approach targets "non-value added overhead," "unproductive expenses," "unnecessary reporting requirements," and "contracted development costs." While working to minimize costs in these target areas has produced some positive returns, the effort does not wholly eliminate these costs for DoD. As Ashton Carter and John Mueller noted in a September 2011 article, "even if you are successful in having some overhead costs shifted off your program, these costs may have to be absorbed by other government programs dealing with the same contractor rather than resulting in actual enterprise-wide savings."[3]

BBP has also prompted some DoD customers to embrace "Lowest Price, Technically Acceptable" (LPTA) proposal evaluations in their quest to reduce expenditures. Under this construct, DoD specifies the desired minimum solution, leaving little room for industry to propose innovative approaches that could result in significant long-term savings.

While the BBP initiatives are well-intentioned, most are likely to produce only modest cost savings that will do little to address the sheer magnitude of DoD's affordability challenge. Finding the dramatic cost reductions that DoD must achieve will require a more holistic view of mission needs and the assumed resources and solutions required to execute them.

CASE STUDY: THE NAVY NGEN ACQUISITION

One recent example of DoD customer cost cutting behavior can be found in the Navy's procurement of its Next Generation Enterprise Network (NGEN). NGEN is intended to replace the legacy Navy Marine Corps Intranet (NMCI) contract, held by EDS (acquired by HP) since 2000, providing an end-to-end IT infrastructure for more than 800,000 users at 2,500 locations worldwide. Considering that NGEN is expected to represent approximately 25% of the Navy's total yearly IT expenditure, the 2012 contract re-compete provided an opportunity for the department to consider innovative solutions to dramatically reduce program cost. However, rather than challenge industry to think creatively and open the competition to a range of providers, the Navy chose to acquire essentially the legacy NMCI solution on an LPTA basis.

The Navy's decision to award NGEN on an LPTA basis is unprecedented. Never before has the Navy used an LPTA evaluation for a contract as large and technically complex as NGEN. In fact, the Navy has generally only selected LPTA evaluations for low-end, non-technical services (e.g., ship husbandry) in the past. For NGEN, the Navy justified the use of LPTA based on its view that the basic contract requirements were "fixed." In choosing to use LPTA, the Navy clearly signaled its desire to achieve significant cost reduction over NMCI.

In reality, however, this goal can only be achieved if additional efficiencies can be introduced, overhead cut, or margin reduced. While the Navy has spent billions on NMCI, an analysis of EDS' financial performance reveals that, prior to 2006, the contract had "…a significant adverse impact on operating results," resulting in major losses for the company during the period between 2003 and 2005.[4] Combined with additional efforts to reduce cost through renegotiation of the contract, it appears unlikely that the Navy will be able to achieve dramatic savings from either the incumbent or a competitor providing an NGEN solution that does not largely diverge from the legacy program.

[3] Carter, Ashton B. and Mueller, John. "Should Cost Management: Why? How?" Defense AT&L, September-October 2011: 14-18
[4] Electronic Data Systems Corporation (2006). 10-K Annual Report, 2006.

INNOVATION THROUGH STRATEGIC AFFORDABILITY MANAGEMENT

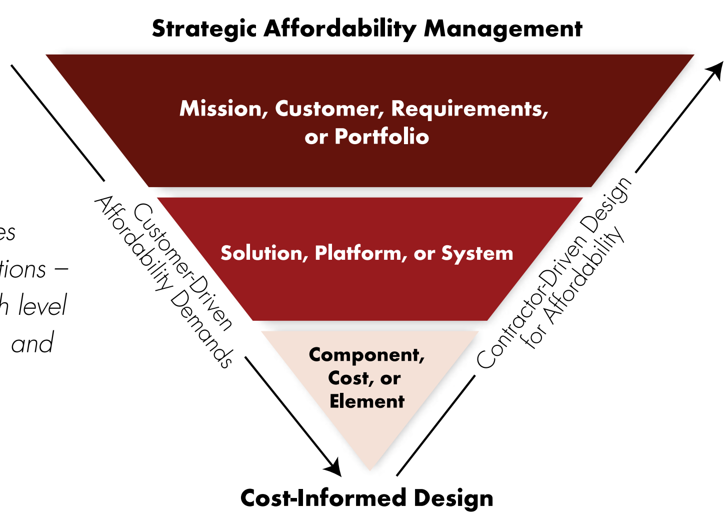
In this environment, contractors have a choice. They can continue to simply respond to customer direction and remain confined to a narrow cost-cutting paradigm. Alternatively, they can engage with customer stakeholders to promote a more strategic perspective on affordability. While the second path is no doubt difficult, the size and significance of the challenge warrants a bold approach by customers and contractors alike. Furthermore, contractors should recognize that if they cannot help DoD to solve its affordability challenge, a competitor likely will, either by offering more innovative solutions or by encouraging cuts and cancellations to free up funding for their own programs.

Contractors and their customers need to view the affordability challenge through a new lens and recognize that there are multiple trade spaces for affordability management that should be considered when evaluating any given DoD program or mission capability (see Figure 1).

Historically, DoD customers have focused the bulk of their effort on pressuring contractors to reduce cost at the component- or element-level of a system (the lowest level in this inverted pyramid). This usually comes in the form of trade studies to find cheaper components and negotiations regarding direct and indirect labor and materials costs. While these efforts have led to some savings, they fail to recognize that material and labor costs are, for the most part, not set by the contractor but rather driven by current market conditions. Moreover, at the point where material and labor costs are typically being scrutinized, particularly in an LPTA setting, the vast majority of acquisition and lifecycle costs have been locked in by the baseline solution directed by the customer.

FIGURE 1: STRATEGIC AFFORDABILITY MANAGEMENT TRADE SPACE

The size of each segment illustrates relative impact of affordability options – actual affordability impact at each level is dependent on program, phase, and trade space



In contrast, DoD customers seldom explore the much larger cost savings potential from changes at the system or even mission requirements level. Trade-offs at these levels hold the potential for radical affordability improvements, yet there is no standing constituency for thinking in these terms. This is due in large part to the nature of the acquisition process, which organizationally and culturally separates budgeting, requirements generation, program management, and lifecycle management. DoD Program Managers are incentivized to execute against stated mission requirements and maintain production within the approved budget scope.

While BBP 2.0 targets "redundancy within warfighter portfolios" and "building stronger partnerships with the requirements community to control costs," it does not recommend fundamentally changing the acquisition process and recognizes that "perverse incentives to spend the budget…need to be countered."[5] Program Managers that overstep boundaries to argue trades between platforms outside of their portfolio, much less argue that their programs are not worth funding, will likely have a short career. The same is true for the other major constituencies as you move up the acquisition decision making chain.

Put simply, contractors must propose bolder solutions to a customer's platform or system requirements as well as new ways to perform critical missions.

Considering that DoD acquisition managers have neither the structure nor incentive to tackle many of these issues, it falls to contractors to think more broadly, focusing on Strategic Affordability Management rather than squeezing cost at the component level of a platform or system. Put simply, contractors must propose bolder solutions to a customer's platform or system requirements as well as new ways to perform critical missions. These solutions are often the result of innovative thinking and challenging traditional views or processes. Opportunities to present these bold solutions come long before a Request for Proposal (RFP) is issued, when DoD is formulating concepts of operation and conducting analyses of alternatives. In this phase, DoD customers can attain the largest cost advantages by manipulating mission focus or portfolio allocation.

[5] Kendall, Frank. "Better Buying Power 2.0: Continuing the Pursuit for Greater Efficiency and Productivity in Defense Spending," Memorandum for Defense Acquisition Workforce, November 13, 2012: 2-7

Contractors therefore need strong customer engagement campaigns built around well researched customer missions, budget trends and compelling business cases. Parallel to that effort, contractors must effectively use that deep understanding of the customer's needs and perspective to develop innovative and affordable solutions as opposed to simply trying to repackage an existing offering in an "affordability" wrapper. Whether these innovative solutions are derived from design-to-cost assessments, competitive analysis of innovative players, or analysis of commercial business models applied to the defense market, the key is to propose real solutions – not just revamp marketing documents to include affordability language.

The US is faced with severe budget and debt issues that must be addressed in order to maintain military readiness and capabilities in an ever dangerous and uncertain world. To overcome this challenge, trust between contractors and their customer must be restored, as must the judgment to make more rational overall buying decisions championed by BBP 2.0. Contractors proposing innovative solutions that combine reliable mission performance with demonstrable cost avoidance and out-year cost predictability can help DoD solve its affordability challenge and restore trust. More importantly, by focusing on affordability through business practice and technical innovation rather than on painful cuts to costs and profits, contractors will also help their shareholders thrive in the new DoD budget environment. Strategic Affordability Management will ensure that the needs of the nation and its defense industry are adequately met.

EXAMPLES: Successful affordability initiatives based on business model and technical innovation to provide critical mission capabilities

- Missionizing or repurposing existing platforms through kitting to meet urgent operational needs while maintaining core capability (e.g., USMC KC-130J Harvest Hawk, USAF MC-130W Dragon Spear)
- Leveraging commercial best practices, suppliers, contracting models, and IT tools to increase system/service reliability and reduce cost (e.g., TRANSCOM DTCI, various enterprise IT and PBL programs)
- Adoption of enterprise IT and business process services solutions that require contractor risk-sharing and leverage commercial best practices (e.g., datacenter consolidation efforts funded within the Energy Savings Performance Contracts, improper payments-focused contracts like CMS' Recovery Audit Contractors contracts)
- Leveraging existing commercial infrastructure to reduce investment and overhead burden for DoD (e.g., commercial satellite communications, virtual data centers)
- Upgrading existing platforms to add game-changing mission capabilities without the development and production learning curve investment costs of new build solutions (e.g., USAF fighter AESA upgrades, USN DDG-51 Flight III)
- Developing solutions that provide 80-90% of the mission capability at 10-20% of the cost (e.g., PGK, APMI)

CONCLUDING SUMMARY

The shear magnitude of DoD's affordability challenge demands tough choices and bold solutions. DoD customers are structurally and culturally incentivized to target cost savings that are painful to industry yet cannot not solve the affordability challenge. Avascent's experience suggests that contractors must take a lead role in helping customers make strategic portfolio trades and developing innovative technical and business solutions that deliver radical cost reductions. Working together, customers and contractors can preserve DoD's mission effectiveness while ensuring the financial viability of the nation and its industry.

Through a series of papers, Avascent will explore a range of issues associated with Affordability and Innovation in federal acquisition.

ABOUT THE AUTHORS:

Jim Tinsley is the Partner lead for Avascent's Capture Support and Price-to-Win practice. He has led the development of core tools and methodologies as well as a number of platform, system, and services capture support and pricing efforts for a wide variety of clients. Jim also manages a number of client relationships with core defense contractors and commercial market companies bringing innovative COTS solutions to the defense market.

Jim Thompson is an Associate and a lead member of Avascent's Capture Support and Price-to-Win practice. He has successfully led numerous competitive intelligence, cost estimating, and PTW efforts for a wide variety of IT services providers, platform OEMs, mid- and large-tier systems integrators, and engineering services firms. Prior to joining Avascent, Jim served as an Air Force Acquisition Manager, leading project teams that contributed to the delivery of space, aircraft, and command and control weapon systems.

ABOUT AVASCENT:

With offices in Washington, DC and Paris, Avascent is the leading strategy and management consulting firm serving clients operating in government-driven markets. Avascent delivers sophisticated, fact-based solutions in the areas of strategic growth, value capture, organizational effectiveness, and merger and acquisition support. With deep sector expertise, analytically rigorous methodologies, and a uniquely flexible service model, Avascent provides clients with the insights and advice they need to succeed in complex market environments.

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