



August 17, 2010

WAYS TO REDUCE COSTS IMMEDIATELY

INTRODUCTION

Fair acquisition policies are needed to maintain a competitive defense acquisition environment and a healthy defense and aerospace industrial base. In order to maintain a competitive industrial base, the government should develop contracting and financial policies that encourage and reward good performance, promote fairness and stability, incent cost savings, and establish balanced and equitable risk-reward financial relationships.

In response to Under Secretary Carter's call¹ for ideas to restore affordability and productivity in defense spending, AIA provided 97 initiatives² that will reduce costs. From that list, AIA has selected several that can be accomplished within current DoD authorities.

RECOMMENDATIONS

Problem Statement: The type of contract DoD uses often does not incent cost savings.

Annual contracts require repetitive negotiations and audits. They do not encourage investment in cost saving technologies or changes in process because there is no expectation of profiting from the savings.

While consuming \$105 billion of the DoD's budget, weapon system readiness remains unacceptably low as the Department continues to use the personnel intensive, massed logistics support policies of the past. This situation contributes to increasing backorders, slow supply chain responsiveness, poor asset visibility, and slow customer response times.

There has been a steady erosion of the streamlined approach to commercial item acquisition. The definition of "commercial item" has been narrowed and over 50 requirements have been added to Federal Acquisition Regulation Part 12 contracts.

Recommendations:

¹ Memorandum for Acquisition Professionals, Subject: Better Buying Power: Mandate for Restoring Affordability and Productivity in Defense Spending, June 28, 2010.

² DoD Efficiency Initiative: Aerospace and Defense Industry Input to DUSD(IP), July 26, 2010.

1. Propose additional multi-year procurements.
2. Increase the use of long term performance- and outcome-based product support contracts.
3. Expand the definition of commercial products to include defense products with competitive direct commercial sales to foreign governments and buys “of a type” and use commercial-type contracts for commercial items.

Savings: The use of multi-year procurements allows industry to strike more favorable deals with subcontractors and encourages industry to make investments that reduce future costs. Administrative costs for annual proposals, audits, fact finding, and negotiations are also reduced. Multi-year procurement savings can exceed 10 percent. The General Accountability Office reported³ that the median multi-year procurement savings for aircraft candidate programs in the 1980s was 10.7 percent and in the 1990s-2000s was 7.2 percent.

Performance- and outcome-based product support contracts provide incentives to increase measurable capability rates while decreasing costs. The OSD Product Support Assessment Team reported that performance-based logistics agreements have saved or avoided over \$1 billion in cost. Comparing FY04 to FY09 dollars per flight hour for one large aircraft platform shows a 28 percent decrease in cost while maintaining an 84-85 percent mission capable rate.

The benefits of employing commercial item acquisition processes are many and widely recognized. The DoD Inspector General's office identified the benefits of commercial acquisition in its audit report, D-2006-115, Commercial Contracting for the Acquisition of Defense Systems, September 29, 2006. Expanding the definition of commercial items allows companies to gain the benefits of using Federal Acquisition Regulation Part 12, so that the government can receive state-of-the-art technology without the delays attendant to its own development process and at a market tested price that compensates producers for their own investments, the costs of which are spread over a considerably larger customer base. Sales to foreign customers are highly competitive, so DoD should be able to use pricing on such contracts in lieu of certified cost or pricing data when it buys the same product. Cost data can be obtained for changes from the equipment sold overseas.

Problem Statement: The current proposal and negotiation process is lengthy and cumbersome and often results in unfairly low returns for contractors.

Contracting Officers assume a reasonable price can only be based on the submission of voluminous cost data – even for commercial items where data may not be available in the form demanded and for items with several lots of production history. Contractors have had to submit extensive amounts of cost data for the C-17 (63,000 pages), F-22 multi-year (94,000 pages), and F-18 (20,000 pages) even though all three aircraft have extensive incurred cost history. Such extensive data submissions take time and effort to compile and review which protracts procurement lead times, increases overheads, and wastes the time of people who could be employed more productively.

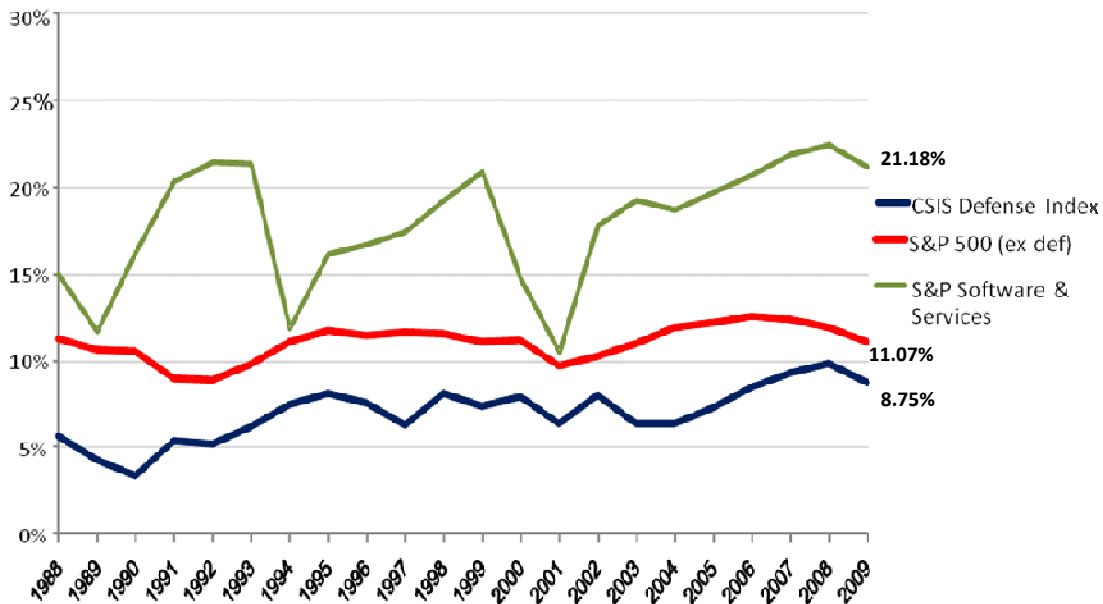
Forward pricing rate agreements were instituted to save the time of having to negotiate rates for each contract and so that experts could deal with the unique issue related to rates. Lately, the government has stopped negotiating forward pricing rate agreements, leaving rates to each individual negotiator. This results in significantly longer negotiations and increased costs in

³ General Accountability Office, GAO-08-298, “DEFENSE ACQUISITIONS: DOD's Practices and Processes for Multiyear Procurement Should Be Improved,” February 2008, Table 3.

personnel time while at the same DoD anguishes because contracts are not being definitized timely. For some companies rate agreements have not been completed in over a year and one major prime contractor has no rate agreements in place at its largest locations.

Defense industry profitability lags significantly behind its industrial peers. Earning a fair return allows the industry to compete for needed resources, provide economic value to its investors, cover legitimate business costs, and continue to provide the best defense systems in the world. In February 2009, the Institute for Defense Analysis, under contract to the Department of Defense, released a report, “Defense Department Profit and Contract Finance Policies and Their Effects on Contract and Contractor Performance.” The report states that the margins for the defense industry are lower than companies in other sectors. The recent history depicted in the following chart demonstrates that the Defense Industry has had the lowest profit performance (operating margins) of any major industry.

Defense Industry Operating Margin—the Lowest Returns Amongst Its Peers



Source: Bloomberg; analysis by CSIS Defense-Industrial Initiatives Group

Notes: (1) CSIS Defense Index comprises 34 publically-traded companies with majority of revenues derived from defense business.

(2) For the S&P 500 CSIS obtained historical data for the period 1988-2009 for the constituents as of July 2010.

For many years DOD has used the Weighted Guidelines to develop profit positions on negotiated contracts. Recently, DoD has arbitrarily cut profits that are offered, often citing the need to save money for DoD or because contractors do not deserve profit on subcontracts.

Recommendations:

1. Reduce the volume of cost or pricing data for all proposals, especially for those where such data does not already exist or for re-procurements when no significant changes have occurred.
2. Re-institute timely enterprise-wide rate negotiation and use of forward pricing rates.
3. Eliminate serial reviews of contractor proposals prior to negotiation.
4. Reinvigorate the use of weighted guidelines to develop profit objectives. Recognize contract technical difficulty and contractor cost saving initiatives.

Savings: Significant reductions are expected on proposal preparation cost and the time required proposing and negotiating contracts. This will result in reductions in number of people involved in the contracting process and a reduction in bid and proposal costs.

Arbitrary and unfair profits on contracts that result in low returns prevent contractor investments and ultimately result in a weakened defense industry, as was seen in the early 1990s as a result of unfair DoD policies.

Problem Statement: The oversight process makes multiple, sometimes contradictory, demands on contractors that drive up overhead costs.

Agencies in the Department of Defense are providing different interpretations of policy that cause contractors who have common systems, to make agency-specific adjustments. For example, DCAA uses its internal control audit planning summary (ICAPS) ratings as a measure of a contractor's system compliance. Lack of consistent policy interpretations result in determinations of inadequate proposals due to immaterial fact finding questions and adverse audit reports for contractor failure to supply unavailable information. Sometimes paper records are stored at a central storage facility and retrieval of the paper record cannot be made within the time frame demanded by the auditor. It is not clear to the contractor, or often to the government officials, where responsibility, accountability, and authority lie when conflicts take place. Such conflicts can delay contract award and drive up costs.

Recommendations:

1. Combine multi-agency compliance reviews.
2. Establish a single point DCMA/DCAA authority at major primes to drive commonality and consistency.
3. Base audits on materiality and risk.

Savings: Quality can be improved through policy collaboration and discussions of technical requirements, selection of acceptable estimating methodologies, and early disclosure of audit findings allowing faster correction of problems. Reductions can be achieved in the number of people supporting reviews, in resolving differences, and in responding to requests for information. Costs can also be reduced in bid and proposal costs and in financing costs incurred while payment actions are being held for government audit.

CONCLUSION

Higher savings can be achieved by the adoption of more significant efficiencies in the following areas:

- Export control reforms (already underway).
- Eliminating non-value added unique requirements that can be identified through an updated Coopers & Lybrand-like study and convening a joint government-industry cost reduction team.
- Requirements reform and stability.

We are working to develop additional, specific recommendations that we will provide to DoD by mid-September.

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