

RESTORING BALANCE IN THE DEFENSE ACQUISITION SYSTEM

Over the past quarter century, more than 300 commissions and studies have produced a variety of recommendations – some of which have become law – to change the way the U.S. military develops and buys new weapons systems. Yet the Department of Defense acquisition system continues to take longer and deliver less in quantity and capability while costs of modernization programs escalate.

The causes are multi-faceted. Fundamental to the problem is the acquisition system itself. In the name of “reform,” government has added volumes of policies, laws and regulations – an average of more than 180 annually over the past three years alone – usually without regard to cost or unintended consequences. These measures are designed to eliminate all risk by preventing any potential miscue or malfeasance. Many were a response to past incidents of abuse – isolated and infrequent, yet highly-publicized – ranging from corrupt government executives favoring certain companies to excessive prices charged on service contracts in war zones.

The perennial clamor for increased oversight has produced burdensome compliance requirements that ignore the complex interrelationships inherent in procuring goods and services through the private sector. And the costs of developing and enforcing a “zero-defect” acquisition apparatus are steep: increased compliance expenses, diminished innovation and delayed delivery of equipment needed by front-line troops and commanders. A mindset prevails that “getting tough” on industry is somehow commensurate with looking out for taxpayers when, in reality, it is the taxpayers – and ultimately our warfighters – who pay the price in the end.

In 1994, Coopers & Lybrand concluded that more than 120 regulatory and statutory drivers added 18 percent to DOD procurement costs. Over the past two decades, oversight requirements have become even more numerous and onerous. Former Deputy Defense Secretary John Hamre estimated recently that compliance mechanisms may add 30 percent to the costs of defense contracts. Dr. Hamre also pointed out that the original contract in the 1960s to send a man to the Moon was written on a single sheet of paper. Today, a DOD contract for procuring even the most mundane item will run into the dozens, if not hundreds, of pages.

In all, the cumulative costs and negative consequences of this accumulation of regulations will exceed the mostly short term and largely illusory benefits to the government. It is a *system grown out of balance*.

Making real progress towards “bending the cost curve” on defense procurement means re-balancing the acquisition system towards measures targeting the relatively rare cases of outright failure and blatant malfeasance. A more balanced system would allow more effort and resources to be expended where they should be: on sustaining the battlefield success and technological superiority of the U.S. military at a time of shrinking defense budgets.

Going forward, DOD should determine, in a more systematic way, whether the cost of an existing or proposed regulation – in financial, operational or strategic terms – outweighs the benefit. Nearly three years ago the Office of Management and Budget (OMB) directed agencies to begin incorporating cost-benefit analysis into considerations of a regulatory action's impact. This OMB directive has had limited impact on the working level of defense acquisitions, as oversight and compliance requirements continue to multiply.

Serious consideration should be given to an immediate moratorium on regulatory activity and new rules should be subjected to a cost-benefit analysis before implementation. As part of this reform, DOD should also commission a comprehensive assessment of the cost and benefit of regulations to both DOD and industry. Using the study's results, DOD would be able to determine which acquisition regulations are essential while eliminating those that, in the end, may actually cost the government significantly more over time – through added delay, higher compliance-related expenses and lower productivity and innovation.

Such an analysis will no doubt reveal the components of DOD's current regulatory regime that do not stand up to scrutiny. The department's audit requirements are a case in point. The vast resources expended on auditing contracts greatly exceed funds recovered from exposing malfeasance. Audits have become more complex, are taking much longer to complete and are delaying contract awards as well as contract closeouts. Applying business-based rules designed to focus on risk and materiality would focus auditors on significant transactions and their impact on overall performance rather than on small dollars which may not influence contract costs when taken as a whole.

It is encouraging that both DOD's "Better Buying Power 2.0" and the Defense Contract Audit Agency acknowledge that audit requirements are a major factor driving lengthy procurement cycles and cost growth. Clearing the backlog of audits, reducing reporting requirements dealing with documentation and subcontractors, and focusing auditors' efforts on potentially problematic aspects of certain contracts rather than delving into a company's entire business operations will reduce the cost of compliance.

A cost-benefit approach to acquisitions would require a de facto "Hippocratic Oath" to avoid new mandates that impose expensive administrative burdens on industry and are costly for the Department to implement. The new reporting requirements on conflict minerals represent an impractical and unaffordable burden.

A section of the Dodd-Frank law requires all Securities and Exchange Commission (SEC) filers – in effect, any publicly traded company – to annually disclose whether they use "conflict minerals" originating from the Democratic Republic of the Congo. Many aerospace companies employ alloys produced with scrap conflict minerals and have complex supply chains, making it impracticable if not infeasible to trace the origins of these materials.

It remains to be seen whether any of this bureaucratic and regulatory churn will deter the impact of murderous groups in Central Africa. What is certain is that the new rules will apply broadly and be costly – very costly. SEC estimates that approximately 6,000 companies could be impacted by the new rules, with initial compliance costs of between \$3 billion and \$4 billion – all of which would ultimately be paid by their customers, including the American taxpayer.

Before going down such a costly and counterproductive path, the administration should direct SEC to re-think and revise the manner in which they are implementing this section of Dodd-Frank. The objective should be the least cumbersome and costly means possible to meeting the law's basic objective, which is to prevent truly egregious cases of profiteering by armed groups in the Congo. Where necessary, legislation should be introduced to rationalize the law's provisions dealing with conflict minerals. In this case, the step not taken will represent a major step forward.

In general, the cost of complying with such a high volume of acquisition regulations could be mitigated if the existing rules were implemented in a sensible way – in the spirit, if not the letter in which they were originally drafted. Defaulting to the most risk averse regulatory environment creates a chilling effect on initiative and openness on both sides of the contractual relationship. Without a doubt, DOD and the aerospace and defense industry are committed to providing the U.S. military with the best possible weapons, equipment and logistics support at a fair price to the American taxpayer. But the pressures inherent in a “failsafe” acquisition regime have pushed government officials to take steps which ultimately prove to be inefficient, ineffective and counter-productive. Typically, there is little consideration of whether discovering a contractor's procedural misstep is worth the added delay and costs.

Commercial items represent a case in point and one example of how regulations and policies drive inefficiencies into the acquisition system. An important provision of the 1994 Federal Acquisitions and Streaming Act was designed to encourage the government purchase of commercial items using a simpler contracting approach than that used when DOD is the only buyer (FAR Part 15). In a commercial contract, the government pays market price for goods or services, just like any other customer would, without access to a vendor's internal information. When DOD is the only buyer of a particular item – typically a product unique to the military – the government seeks access to a company's internal cost data and business records to ensure that the price paid is fair and reasonable. In addition to providing for greater economies of scale, using commercial contracts attracts companies who would otherwise be deterred by the cumbersome process of bidding on and complying with a typical defense contract.

That was the intent. In reality, over the years the promised streamlining has been increasingly undermined – this despite the clear guidance provided by DOD's own regulations to have a preference for commercial items and technologies. Contracts for commercial items and technology that could – and should – be categorized as commercial items are instead being treated more like government-unique acquisitions, with all the associated data requests and reporting provisions that can be so prohibitive to commercial firms.

If contractors are expected to invest resources and know-how into defense platforms and products, they should be able to maintain rights to the resulting data. New intellectual property rules and policies upend this logic and threaten to erode the competitive advantages companies invested in and are banking their futures on. These rules and policies assume a contractor will continue to commit its own valuable resources to programs that, if successful, could result in their competitors reaping substantial rewards by having access to technical data that they did not pay for or invest in.

As it stands, under existing authority the government is provided the sufficient amount of internal data it needs under commercial contracts. This has been the experience of the intelligence community, which is increasingly turning to commercial items to meet its most demanding and urgent technology needs. The Defense Department should train, manage and incentivize its acquisition workforce to use existing tools and business practices effectively. Ensuring the acquisition workforce is well trained in typical business practices, including how to conduct market research, would raise confidence in their professional judgment and make them less likely to move away from opportunities to use streamlined contracting approaches.

Restricting the use of commercial contracts and forcing vendors to relinquish their intellectual property deters companies from competing for defense business, denies warfighters prompt access to technologies readily available on the open market and limits the government's access to the best thinking and talent available in the private sectors.

DOD should and does expect to pay a fair and reasonable price for goods and services. However, efforts to limit contractor profits and compensation have a similar influence on the industrial base as do onerous regulations. Each is based on the tempting – but ultimately self-defeating – premise that it benefits the government to make defense contracts less attractive for companies, the people they employ and their investors. At this time the profit-margins for aerospace companies on defense contracts are below margins on comparable commercial contracts. Yet in recent years, initiatives such as using fixed-price contracts when the risk calculus would suggest a different approach, shifts the uncertainties inherent in complex systems to contractors and restricts incentives to push technology forward. On top of the aforementioned regulatory burdens, these initiatives are making it more difficult for companies to justify their participation in the defense market to shareholders and investors.

Similarly, restrictions placed on contractor compensation, while politically popular, make it more difficult for companies in the defense sector to retain and attract the most talented employees – especially those scientists and engineers whose knowledge are in high demand. The government may lose access to critical skills needed to design and build the tools our military needs.

DOD's most recent initiative – “Better Buying Power 2.0” – is intended to rectify some of the system's long-standing shortcomings while improving on recent internal and congressional attempts at reform – including “Better Buying Power 1.0” and the Weapons System Acquisition Reform Act of 2009. Without a collaborative dialogue between government and industry which seeks to fully understand how these policies will actually be implemented, this new initiative – like so many of its predecessors – will have unintended consequences.

The cumulative result of moving ahead with these regulations is fewer companies introducing fewer innovative technologies for military use. In the long run, the costs of these initiatives would outweigh any marginal benefit or perceived savings to the government.

These examples describe an acquisition system in urgent need of procedural reform and cultural transformation. We applaud Under Secretary of Defense Frank Kendall and his ongoing effort to bring positive change to the acquisition culture, but more needs to be done. By taking prompt action in the key areas described above, the government can begin to achieve a better alignment between the stated objectives of DOD's acquisition processes and their real world consequences. And we stand ready to work with Under Secretary Kendall, to collectively improve how America buys the goods and services essential to our nation's defense.

We are cognizant that it will be difficult to unravel decades of bureaucratic practice and culture. However, we believe that applying a more balanced, common-sense mindset to the most pressing acquisition challenges can have an immediate impact that lays the ground work for more systematic change over time.

Failure to make progress in these areas will only further drive up costs at a time when it is incumbent on all of us to make every defense dollar count.