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The author:

Steven C. Grundman
Vice President and Director,
Aerospace & Defense Consulting
Boston
+1-617-425-3168
sgrundman@crai.com

The Monopsonist's Dilemma

Implications for the Defense Industry of *Better Buying Power* at the Pentagon

At a press conference held two weeks ago, US Secretary of Defense Robert Gates and his acquisition executive, Ashton Carter, announced Carter's issuance of direction for how the Pentagon would set out to achieve productivity growth in its acquisition of weapons and procurement of services. The details of the new direction are contained in Carter's 17-page memorandum, dubbed *Better Buying Power*.[1] The memorandum promulgates 23 distinct directives that will represent the acquisition community's contribution to the five-year, $100 billion Efficiency Initiative that Secretary Gates indicated would be the focus of his legacy as Secretary of Defense.

The document's anodyne headings and arcane details disguise an initiative of profound significance for the defense industry. It is the most important expression of US defense-industrial policy since July 1993 when then-Deputy Secretary William Perry convened the captains of industry for what came to be called the "last supper," a meal over which he issued direction that set in motion the Darwinian restructuring of industry which ensued across the following decade. *Better Buying Power* is instead addressed to the cadre of acquisition professionals who work for Carter and ostensibly directs only buyers' procurement practices. But, like Perry's direction, its successful implementation would change many of the key tenets of doing business with the Pentagon that drive competitive advantage, financial performance, and the structure of industry.

It is the purpose of this paper to appraise those changes. The invocation of "buying power" in the initiative's title calls to mind the balance of market power between buyers and sellers microeconomists ascribe to industrial structures in which many sellers face a single buyer—monopsony. *Better Buying Power* certainly reads like the monopsonist's playbook for defense in the 21st century. However, this same invocation of buying power is likely to color its reception by industry, evoking the classic dilemma which the exercise of monopsony sets up: How to incentivize lower prices in the short-term without ruining suppliers' incentives to commit assets, incur risk, and innovate for the long-run.

The dilemma. A central direction in the Guidance is to promote competition by implementing various tactics that would have the effect of limiting the scale, scope, and duration of individual contract opportunities. In addition, *Better Buying Power* implies a

[1] See http://www.acq.osd.mil/docs/USD_ATL_Guidance_Memo_September_14_2010_FINAL.PDF?transcriptid=4648

change to the economic model of defense contracting. It moves away from a model that prizes the delivery of product performance on a predominantly inputs- or cost-basis and toward one that puts a premium on meeting schedule and cost—collectively, what I'd term responsiveness—on a mostly outputs- or price-basis. While I'd be the first to acknowledge how hard a full implementation of Carter's direction will be to achieve, these changes nonetheless should give pause today to any defense industry firm that currently has a corporate development plan predicated on extracting value from a vertical or lifecycle integration strategy. At the least, firms should acknowledge that many of the key themes of the defense industry's post-cold-war restructuring—concentration into pure-plays, vertical integration, diversification into services—were in no small part a reflection of customer preferences this memorandum now specifically disavows.

Having said that, Carter plainly understands that he will not succeed at inducing private firms to undertake projects for which their expectation of returns does not cover their cost of capital. At the same time, it's equally plain that he wants to change the customary business model of defense procurement from one characterized by level-of-effort resource management and predictable margins over long contract durations to one that puts a higher premium on flexible assets and risk management practices to enable firms that carefully mange costs to earn high returns. The tension between these two objectives illustrates the classic dilemma faced by a customer with market power who wants to drive prices as close to marginal cost as possible while at the same time incentivizing commitment, quality, and innovation.

This monopsonist's dilemma is most sharply framed in the memorandum's direction to formulate acquisition strategies that involve competition *at each milestone in development*. Carter calls out as exemplary the novel acquisition strategy of the Littoral Combat Systems, which plans a new competition for production of the ship-class after the Navy downselects a design. In other words, incumbency at any particular milestone would no longer secure the prize of revenues and profits flowing from the next milestone, a policy that makes a sharp break with the scheme to incentivize innovation around which the defense industry of today is largely organized.[2]

It suffices to say that the prospect of a customer determined to make better use of its buyer power presents a dilemma for suppliers too. On the one hand, who's to argue with the merit in a smarter customer advancing business practices that incentivize both the military departments and defense contractors to squeeze out non-value-added programs, capabilities, practices, and activities? On the other hand, in circumstances where budgets are not growing, competition becomes the primary mechanism of those incentives, so the distribution of efficiency gains will not be uniform. There are sure to be winners but also losers.

Other shoes to fall. To begin with, the memorandum signals a further culling of acquisition programs beyond those in Gates's sweeping announcements of April 6, 2009, which set the tone for this administration's stewardship of the DoD budget. Under the heading "Eliminate redundancies within warfighter portfolios," Carter hails the Army's intention to cancel the Non-Line-of-Sight Launch System (NLOS-LS) as a sensible choice derived from comparing the system's unit cost to the increment of capability it contributes within the context of the service's entire portfolio of precision weapons. In endorsing the Army's decision, Carter's emphasis on the "narrow capability" of the NLOS-LS echoes Secretary Gates's repeated complaint about acquisition programs that offer exotic or exquisite capabilities but in too small a niche to justify their high cost. Not leaving us to wonder in which other mission areas he envisions such redundancies, Carter indicates that he will supervise similar portfolio reviews, starting with Ground Moving Target Indicator (GMTI) and Integrated Air and Missile Defense systems. He also is directing the military departments to do likewise for warfighting portfolios under their respective purviews. Not least, Carter sets 120 percent of a contract's target price as the mark above which "in an era of relatively flat defense budgets [programs] should face review with an eye to cancellation."

In one sense, there's nothing particularly new in this pronouncement to rationalize the overlapping and complementary capabilities of different weapon systems, and set thresholds of cost growth that prompt a review. It's the stuff of systems analysis dating back to the advent of the McNamara Pentagon, after all. So how do incentives and competition figure into Carter's take on the tradition? In two ways. First, in articulating what he tellingly calls a "classic value decision," Carter heightens awareness—which in an era of growing budgets may have become blurred—of the hard reality that systems within a common mission area are in direct competition with one another for budgetary resources.

[2] William P. Rogerson, *Profit Regulation of Defense Contractors and Prizes for Innovation*, (Santa Monica: The RAND Corporation, 1992).

Along the way, he also sanctifies incremental net benefit as the measure of comparative merit. Second, he reiterates an incentive enunciated in Secretary Gates's Efficiency Initiative that the military departments shall retain the monies they save through such choices to pay their other bills, not risk those savings being siphoned off to fix shortfalls in other components of the Department of Defense.

Bogeymen. There are two bogeymen circulating about *Better Buying Power* for which I find no substantiation in the memorandum, the press conference, or, more importantly, the economic logic of the actions Carter is directing. The first phantom is that the initiative is inspired by a plan to solve the department's future budget shortfalls by making a run on the profits of its suppliers. The second is that *Better Buying Power* will mandate the use of fixed price-type contracts to develop advanced weapons. To begin with, the document itself goes out of its way to dispel both fears. As to profit policy, Carter writes,

> "It is important to note that the savings to be expected from this direction will be in cost, not in profit. Savings are not expected in profit *per se* since in some instances profit will increase to reward risk management and performance. But if profit policy incentivizes reduction in program cost, the overall price to the taxpayer (cost plus profit) will be less."

With respect to contracting practices, the Guidance states,

> "Choosing contract type is one important way of aligning the incentives of the government and the contractor. One size does not fit all. At one time, the Department attempted to impose fixed-price contracts on efforts where significant invention (and thus unknowable costs) could be anticipated. . . . 'Fixed Price' is appropriate when the government knows what it wants and does not change its mind, and when industry has good control of its processes and costs and can thus name a price. While these conditions do not always exist (as in, for example, a risky development where invention is needed), they are certainly desirable, and both parties to the contract should aspire to fulfilling them."

These assurances notwithstanding, we should make no mistake that the Guidance *does* intend to use the incentive of profit to motivate choices about what's valuable and what's not, and that Carter sees cost-plus-type contracts as having the weakest mechanisms to incentivize smart trade-offs. In the profit and cashflow policies Carter is directing his staff to codify into acquisition regulations, suppliers who successfully manage cost and risk are supposed to enjoy exposure to outsized rewards as compared to today's practices, while those unable to exercise such discipline will not. That sharpening of the gradient between success and failure in defense contracting could have a big impact on the business of defense in the United States, to be sure. But those observations and the conviction to act on them are a far cry from the association of *Better Buying Power* with certain ham-fisted swipes at the defense industry that have long since been discredited.

War on incumbency. A far more substantial threat to the defense establishment shows itself in the several directives designed to invigorate competition and lower barriers to entry. I think it's not an exaggeration to say that *Better Buying Power* has taken aim at eradicating what it views as a sclerosis of comfortable contractor incumbency. For example, in addition to directing acquisition strategies that envision competition at each development milestone, the memorandum also directs:

- The adoption of a standardized taxonomy of service-types, standardized Performance Work Statements, and more standard weighting of source selection factors. The memorandum is carefully worded on these points but it's pretty clearly targeted at undermining the art of crafting solicitations that limit rather than attract offerors. Today, the defense industry puts a lot of its business development effort into "shaping" requirements and the particulars that show up in requests for proposal. In undertaking these tactics, incumbents' knowledge of and day-to-day proximity to customers is one of their chief advantages. These directives are aimed at sharply eroding those advantages.

- The treatment of ostensibly full-and-open solicitations that attract only a single offeror as "ineffective competition" that does not meet the standard of "adequate price competition," which otherwise would permit an award without negotiation of the proposed price. So, where incumbents or others' successful business development strategies do succeed at dissuading any competitors from taking them on, Carter wants to ensure the winner does not enjoy business terms untamed by market discipline, *even under circumstances when the winner might well have expected competition*.

- The adoption of open systems architectures, acquisition of technical data rights, and breakout of subcontracts where necessary to facilitate competition for sub-systems and components both in original equipment and lifecycle product support. Carter commends the acquisition strategy of the Navy's Virginia-class attack submarine program for its adoption of open standards and purchase of the data rights for selective components. It will take time and, not least, up-front money for these policies to have a broad effect, but even the simple customer preference they express should give pause today to any of industry's corporate development plans predicated on extracting value from a vertical or lifecycle integration strategy.

- The recompete of contracts for services at shorter intervals. Henceforth, three years will be the standard duration for any single-award services contract. Multiple-award indefinite-delivery/indefinite-quantity contracts may extend to five years, he says, but only if the procurement strategy includes "on-ramp" provisions that would enable new firms to join the pool of competitors mid-stream.

- The promotion of small business participation in DoD programs. I originally looked past these provisions and assumed they comprised no more than the perfunctory genuflection to small business that is *de rigueur* in pronouncements about government contracting. But upon closer inspection, one can read how the memo actually frames its direction on small business as a fillip to competition. In particular, it credits small businesses with higher rates of innovation and lower costs that can challenge larger incumbents if given the selective advantages they often need to just get to the table.

Taken together, the full implementation of these initiatives would change the competitive landscape of defense contracting against the interests of incumbents. Of course, one program's incumbent is the next opportunity's competitor, so it's not clear whether these provisions, on net, are adverse for the industry as a whole or even any one company in particular. But they do signify change to which all competitors will need to adapt.

TSPR RIP. About a decade ago, at roughly the mid-point of the industry restructuring set in motion at Bill Perry's "last supper," the department adopted a collection of acquisition policies and practices under the rubric Total Systems Performance Responsibility or TSPR (and pronounced "tis'-per"). The customer preferences reflected in TSPR favored the increased outsourcing of certain functions in the cradle-to-grave lifecycle of acquisition programs which during the Cold War had been shared between government and industry. At the upstream end of that cycle, the acquisition workforce at military departments' laboratories and engineering centers shrank dramatically, both in size and significance, ceding to industry the critical design and system engineering and integration functions at the center of acquisition programs. At the apex of this trend line emerged the concept of the so-called Lead Systems Integrator, which subsumed not only the systems engineering function but even large parts of the concept development function, and not only for discrete weapons but entire warfighting mission areas like missile defense (see Ground-Based Midcourse Defense) and ground combat (see Future Combat Systems). At the back end of the lifecycle, the military maintenance depots, which had been significantly reduced through successive rounds of base closure, were refocused on "core" maintenance functions, opening the door to a variety of practices tying the original equipment manufacturers to the provision of maintenance services. Through that door came product support strategies with snappy titles like Contractor Logistics Support, Performance Based Logistics, Public-Private Partnerships. A not insignificant degree of industry's restructuring was undertaken as a corporate-strategic response to these developments. Indeed, many of the key themes of the defense industry's restructuring —concentration into pure-plays, vertical integration, diversification into services—were undertaken in response to the customer preferences for which TSPR is emblematic.

Setting down *Better Buying Power*, one can't help concluding those preferences are sharply changed. Where before the customer looked to industry to lead its upstream science, engineering, and program management, the Guidance reiterates that "the [government] acquisition workforce increases planned last year should proceed . . . focused on specific skill sets near to the point of execution." The Guidance calls into question the efficacy and efficiency of so-called SETA (systems engineering and technical assistance) contractors who support military program offices, comparing their value unfavorably to the government workforce and non-profit research centers. It openly threatens to break out from prime contractors' scope of responsibility any subsystem and even component it thinks industry is not managing for adequate value. Turning the tables on TSPR almost completely, the Guidance even indicates the DoD now will seek insight and oversight about defense contractors' Independent Research and Development spending, "to align the purpose of IRAD to actual practice."

Of course, over the years of experimentation with TSPR, it had long since lost its luster. Now it's officially dead. The significance of its passing for industry will not come all at once; it will take time for the Pentagon to rebuild the acquisition workforce that makes possible greater government control over the conduct of acquisition programs. Furthermore, I do not think the pendulum will swing all the way back and resurrect practices more common during the Cold War when industry's role in the acquisition lifecycle was largely confined to providing discrete, specified inputs to the military's huge establishment of labs, materiel commands, and depots. But even if the pendulum swings only half-way back to those practices, it will decisively change how prime contractors create value for their customers and shareholders.

No new acronyms. "DO MORE WITHOUT MORE" is the all-caps exhortation that culminates the very first paragraph of the Guidance. Fortunately, beyond coining that strained aphorism, the memo is refreshingly bereft of sloganeering. Indeed, any appraisal of the Guidance would be incomplete if it failed to take notice of the memorandum's distinctive themes and tone, which speak volumes about the aim and heft of this initiative.

Longstanding observers of the Pentagon may be excused a reflex of cynicism toward this latest installment in a decades-long succession of mostly ineffectual campaigns to wring better value out of what the DoD gets for its billions. And yet, against the backdrop of this dismal legacy, *Better Buying Power* manages to distinguish itself as much for its reticence as its ambition. It establishes no new organizations to cheerlead the campaign, which in the past have tended to deflect responsibility for implementation away from those with the authority to effect change. It describes no new wiring diagrams of procedure to create the illusion of automation in sensible decision making. It also resists simple reiteration of several enduring precepts whose popularity owes more to their success at animating the *form* of change than enabling the *substance* of hard choice.

Instead, the document's style makes liberal use of active verbs and first person singular nouns, as in, "I will set a range of approved production rates." It invokes no magic from familiar rallying cries, like "Joint," "Reform," or "Integrated Product Teams." And it mercifully conjures no new acronyms, preferring plain-spoken mandates—"Treat affordability as a requirement"—to puffed-up change programs organized under preposterous labels like "CAIV."[3]

This refreshing style not only distinguishes *Better Buying Power* from its hortatory antecedents, but more significantly for the defense industry, it says a lot about the top-down, personal commitment of Gates and Carter to this endeavor and the solemn calculation of their intent. It reflects an acquisition executive who understands that no organizational superstructures can effect lasting change without an infrastructure of economics that gets the incentives right. Indeed, the term *incentives* is this campaign's refrain, appearing 13 times in the document (bested only by *competition*, which is invoked no less than 50 times!). At the roll-out, Carter's terse response to a reporter's suggestion that the initiative "would seem to require a cultural change within the Department of Defense" was a telling moment. "I don't do cultural change," replied Carter.

> "This is directing specific actions . . . and the cause-and-effect is pretty specific . . . and the metrics by which we measure the effects are spelled out in the document. So culture's too hard for me. Behavior, that's what we're after."

I think that says we can take Acquisition Reform Day off our calendars.

Command-and-control. I applaud Carter's instinct to relegate concerns about the superstructure of changing defense acquisition practices. However, that posture does beg important questions of how he intends actually to ensure full and faithful implementation of so many fundamental changes across the entire $400 billion of contracting the Department of Defense undertakes every year. Absent some kind of transmission belt for these far-reaching actions, their realization mostly relies on command-and-control-styled rules administered by a distributed cadre of acquisition executives, who will face the challenge of having to understand and gauge correctly the very subtle choices these practices frame for decision. With respect to many of the variables in an acquisition or contracting strategy that the Guidance identifies as driving value, it goes on simply to set out an optimal value or "point of departure," the boundary conditions that are tolerable under a range of conditions, and the authority to approve deviations from those parameters. For example, the directive to "make production rates economical and hold them stable" concludes with the following implementing instructions:

[3] Cost As [an] Independent Variable.

> "I will expect production rate to be a part of the affordability analysis presented at Milestones A and B. Furthermore, at Milestone C, I will set a range of approved production rates. Deviation from that range without my prior approval will lead to revocation of the Milestone."

Juxtaposing the apparent simplicity of this approach to implementing the Guidance against the mammoth ambition of the 23 directives will no doubt prompt critics to ascribe naïveté, overreach, or both to this bold secretary and his self-described "relentless" under secretary. At the same time, Carter makes clear that the application of this Guidance only applies going forward and will focus where the dollars at stake are the largest. They do not plan to right all wrongs all at once, and I suspect they are prepared to pace the full application of this Guidance to lesser programs with the rate at which they can find qualified people to fill out the acquisition workforce. It also has to be said that the magnitude of increased productivity that is their target is not outrageous. If, as Carter repeats, the implementation of this Guidance can yield a "substantial fraction" of the $100 billion/five-year goal of the Efficiency Initiative, that implies savings amounting to something under five percent of the $2 trillion the department is projected to spend on goods and services over that timeframe.

Moreover, an approach that combines the under secretary's savvy at orchestrating economic incentives with the secretary's penchant for making difficult decisions elevates the prospects for this initiative above the dustbin where most of its predecessors came to rest. It's worth noting, in this regard, that Carter's issuance of such a detailed Guidance document a full week ahead of the "before-the-end-of-summer" deadline he set at the campaign's launch in late June is no small bureaucratic achievement which impressively underscores the priority both men attach to this campaign.

The presentation at the September 14 press conference apparently struck one reporter as "a very industry-friendly briefing." "Where are you tightening up punitive measures or penalties?" he wanted to know. And indeed, those in the press or politics who would have liked this announcement to stoke our history's habit of vilifying the arms industry following periods of high growth in defense spending were no doubt disappointed by all this mumbo-jumbo about incentives, risk, and contract types.

But that very welcome deviation should not obscure from those in the defense industry the great significance of *Better Buying Power* to their businesses. There's a profound industrial policy implied by the acquisition practices it directs. Successfully implemented over time, it would demand of industry much more than the simple belt-tightening that has comprised the initial responses. It challenges prevailing business models, and in turn, the very structure of the industry. The exact course of *Better Buying Power's* ultimate impact on industry is hard right now to discern, not least because its implementation is fraught with uncertainties. Regardless, this very direct, detailed, and personal expression of how the secretary and under secretary want the market for defense goods and services to work marks some kind of post-Iraq War inflection from the trajectory of defense-industrial policy that was last so clearly set 17 years ago.

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