

Department of Defense Infrastructure Resources
A SYMPOSIUM ON KEY MANAGEMENT INITIATIVES

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INTRODUCTION

It is widely known that the Department of Defense infrastructure—its central supply and maintenance activities, medical facilities, institutional training base—consume the majority of its resources. It is also known that the affordability of out-year modernization efforts depends to a great extent on achieving savings in the infrastructure and the costs of “owning” major defense acquisition programs. To this end, the department is implementing significant initiatives to reduce costs and improve quality in its operations. Savings from the Base Realignment and Closure Commission process are programmed to take care of some of this. Other initiatives include privatization and outsourcing, strategic planning, and performance-based budgeting. Collectively, these efforts will profoundly affect the way the department does business, particularly in its infrastructure.

Most conferences for resource managers and analysts deal with the major defense acquisition program areas. This symposium was different from other gatherings in that it brought together the people most closely involved with implementing the various initiatives in the infrastructure arena. The symposium, hosted by the Logistics Management Institute on November 29, 1995, consisted of four panels that addressed the following topics:

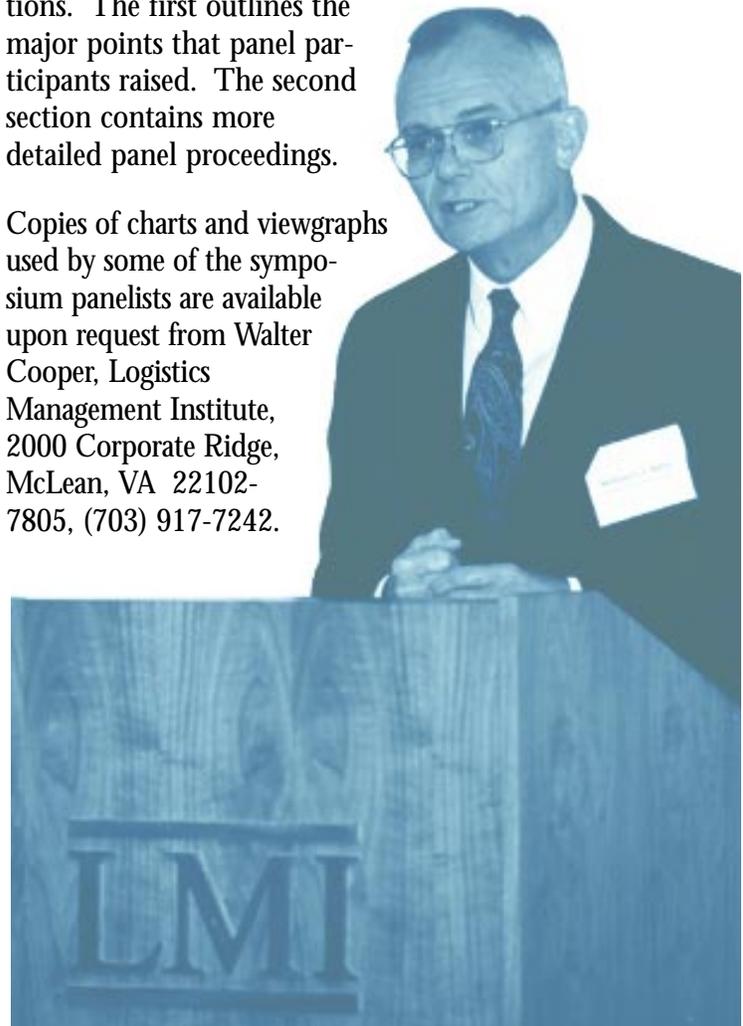
- ◆ Pricing goods and services under the Defense Business Operations Fund

- ◆ Performance budgeting in defense agencies
- ◆ Accountability and results in business process reengineering
- ◆ DoD privatization and outsourcing.

Attendees included senior representatives from the Office of the Secretary of Defense; the military services; a number of defense agencies; and several organizations outside DoD. A complete listing of attendees, by agency, can be found in Appendix A.

This report consists of two sections. The first outlines the major points that panel participants raised. The second section contains more detailed panel proceedings.

Copies of charts and viewgraphs used by some of the symposium panelists are available upon request from Walter Cooper, Logistics Management Institute, 2000 Corporate Ridge, McLean, VA 22102-7805, (703) 917-7242.



Panel 1

Pricing Goods and Services in the Defense Business Operations Fund

Panel Members

Mr. Milt Margolis
(Moderator)

Senior Fellow, Logistics
Management Institute

Mr. John Beach

Principal Deputy Assistant Secretary
of the Air Force (Financial
Management and Comptroller)

Dr. Craig College

Chief, Force and Infrastructure
Cost Analysis Division, Program
Analysis and Evaluation
Directorate, OSD

Ms. Joan Freeman

Resident Fellow, Logistics
Management Institute

Mr. Bill Coonce

Director, Revolving Funds, Office
of the Undersecretary of Defense
(Comptroller)

Dr. Bill Rogerson

Professor, Department of
Economics, Northwestern
University

SUMMARY OF PANEL DISCUSSIONS

Pricing Goods and Services in the Defense Business Operations Fund

The panel on pricing goods and services in the Defense Business Operations Fund (DBOF) was moderated by Milt Margolis, Senior Fellow, Logistics Management Institute. Panelists included Mr. John Beach, Principal Deputy Assistant Secretary of the Air Force (Financial Management and Comptroller); Dr. Craig College, Director, Force Structure and Infrastructure Cost Analysis Division, Program Analysis and Evaluation Directorate, OSD; Mr. Bill Coonce, Director, Revolving Fund, Office, Under Secretary of Defense (Comptroller); Ms. Joan Freeman, Resident Research Fellow, Logistics Management Institute; and Dr. Bill Rogerson, Department of Economics, Northwestern University.

BACKGROUND

Large commercial firms have learned that they can decentralize decision-making and achieve the economic efficiencies of the competitive process by the proper use of transfer prices among individual internal operations set up as service centers. Doing so involves setting the price of internally supplied inputs equal to the marginal cost of producing them, asking users to be aware of external prices, and making it possible for them to purchase certain goods and services from external suppliers. Transfer prices set in this way motivate users to make efficient usage decisions and suppliers to be more efficient.

DoD's DBOF system now sets rates in accordance with a break-even principle, under which service centers identify products and charge prices for them so that their expected

revenues will equal their expected costs, including any prior year losses. These rates are fixed and set for long periods before costs are actually incurred.

Under the break-even principle, transfer prices are primarily a funding device rather than a device for decentralizing decisions. While this approach may be a neat and tidy means of funding, it is not a means for efficiently allocating resources. This approach induces the users of internally supplied inputs to make decisions that may be rational in their own interest while not minimizing costs for DoD as a whole. For example, local centers often choose to produce goods locally at a higher cost than centrally fabricated items because of the fully loaded price DBOF attaches to those same items. It does not motivate suppliers to become more efficient by making their survival dependent upon setting competitive prices.

DISCUSSION

The discussants primarily addressed the questions of whether and how the DBOF rate-setting system should be modified to more effectively motivate users and suppliers to improve their efficiency. All of the discussants agreed that the use of transfer prices to achieve economic efficiencies—a process not begun by DoD with DBOF but attempted in the use of stock and revolving funds going back to the 1940s—should be continued. It was also generally agreed that major improvements in DBOF price-setting policy could be made to achieve more decentralized decision-making and more efficient resource usage. Further, it

was agreed that this could be done despite the risk-averse posture of DoD relative to private business and the need of the department to maintain its warfighting mission. Finally, it was agreed that DBOF could pursue more economically productive price-setting policies without completely abandoning the financial break-even approach, if certain discreet modifications were made to the system as discussed in the next two paragraphs.

All of the discussants agreed on the need for improvements in the DoD financial reporting system to *identify the costs of producing internal inputs* in the first place, before they could be used more extensively as the basis for setting prices. All agreed that such accounting changes require a major and possibly costly effort but are essential to turning DBOF into a truly business-like operation.

A number of the discussants also agreed that, if prices are to be an incentive to a customer, *prices cannot represent total costs that include indirect and fixed costs* as DBOF prices now do. One proposed solution to this problem, while still roughly adhering to the break-even approach, was to charge for the production of nonmarketed outputs and for fixed costs with fixed fees levied directly on operational commands and other units.

RECOMMENDATIONS

Discussants believed that DoD should take the following actions:

- ◆ Examine DoD's current financial reporting systems with an eye to introducing those changes that would give visibility to the costs of goods and services produced internally, both at local and centrally managed facilities. Concentrate on activities such as maintenance or supply, where it is believed improved resource allocation could achieve significant savings. Calculate the cost and time involved in introducing such accounting changes, and make estimates of the potential savings achievable in the nominated activity areas.
- ◆ To improve further the visibility of incurred costs and particularly interorganizational transfers, extend the information included in current Future Years Defense Program (FYDP) DBOF elements to identify where DBOF revenues are derived. (Thus, these program elements would reflect measurements of mutually exclusive resources and not just obligational authority transfers, making the FYDP a more useful programming and budgeting document.)
- ◆ Update prices more frequently to provide flexibility to encourage customers and suppliers to behave more rationally. Decentralize the setting of prices for individual goods and services as much as possible.
- ◆ Set transfer prices for internally produced goods and services equal to their marginal cost. Do not include the cost of nonmarketed outputs and fixed costs in these prices. This will motivate customers to make choices that are economically rational for DoD as a whole.
- ◆ Move toward a system that levies fees directly on operational commands and other user units to cover the costs of nonmarketed outputs and the fixed costs of production. (This recommendation represents the views of a majority of the discussants, but by no means all of them.) ❖



Panel 2

Performance Budgeting in Defense Agencies

Panel Members

Mr. Irv Blickstein
(Moderator)

Director, Acquisition Program
Integration, Office of the
Undersecretary of Defense
(Acquisition and Technology)

Mr. Richard Keevey

Director, Defense Finance and
Accounting Service

Mr. Roger Sperry

National Academy of Public
Administration

RADM (Sel) Justin D. McCarthy

Comptroller, Defense Logistics
Agency

Dr. David McNicol

Deputy Director (Resource
Analysis), Program Analysis and
Evaluation Directorate, OSD

Performance Budgeting in Defense Agencies

“The Law...requires that we chart a course for every endeavor... see how well we are progressing, tell the public how we are doing, stop the things that don't work, and never stop improving.”

President Clinton
August 3, 1993

Pr. Irv Blickstein, Director, Acquisition Program Integration, Office, Under Secretary of Defense (Acquisition and Technology), moderated the panel on performance budgeting. The panelists were Dr. David McNicol, Deputy Director (Resource Analysis) in the Program Analysis and Evaluation Directorate; Rear Admiral (Select) Justin D. McCarthy, Comptroller, Defense Logistics Agency; Mr. Richard Keevey, Director, Defense Finance and Accounting Service; and Mr. Roger Sperry, National Academy of Public Administration. What follows are the broad themes that emerged from their presentations and the subsequent discussion of performance budgeting implementation.

BACKGROUND

Recent initiatives in both the legislative and executive branches of the government call upon federal government managers to shift their focus from managing inputs to managing for results. Legislation has included the Chief Financial Officers Act of 1990 and the

Government Performance and Results Act of 1993. The Clinton Administration's National Performance Review, led by Vice President Al Gore, complements these laws. Departments and agencies have begun pilot tests designed to pave the way toward implementation of these initiatives, which focus on linking performance with budgets—the concept known as performance budgeting.

Performance budgeting seems to work best when there is direct accountability between what an agency does and what it wants to happen.¹ Among the 13 major defense agencies, several appear to be good candidates for performance budgeting, and some of these have started implementation programs. The Defense Commissary Agency, Defense Contract Audit Agency, Defense Finance and Accounting Service, Defense Investigative Service, Defense Information Systems Agency, Defense Logistics Agency, Defense Mapping Agency and Department of Defense Education Activity all seem to have characteristics that make the use of performance budgeting promising.

¹Congressional Budget Office, *Using Performance Measures in the Federal Budget Process*, Washington, DC, July 1993, page xii. The federal agencies evaluated were the Environmental Protection Agency, the Internal Revenue Service, the Department of Labor's Employment and Training Administration, the Farmers Home Administration, the Department of Defense and the Public Health Service's Healthy People 2000 program.

IMPROVING PRODUCTIVITY THROUGH INPUT ADJUSTMENTS

The Defense Finance and Accounting Service (DFAS) has moved aggressively to streamline operations to increase effectiveness and efficiency. Examples include the following:

Organizational consolidation has reduced the number of major finance centers from 6 to 5, and is reducing the number of finance and accounting offices from 330 to 21.

Systems modernization involves upgrading and standardizing the various DFAS finance and accounting systems to improve overall performance by reducing the number of dissimilar operating systems and eliminating many personnel now required to maintain redundant and inefficient systems.

New technologies are being introduced whenever cost-effective opportunities present themselves to save costs and to improve output. Potentially high-payoff areas exist in new technologies to substantially reduce our dependence on "hard copy," such as electronic commerce and electronic data interchange (EDI), and in solving the problems of document handling with new imaging technologies.

Business process reengineering entails continuous exploration for ways to modify current internal practice or processes to gain improvements in cost and quality.

PERFORMANCE MEASURES

Other Agencies, Similar Challenge

Developing effective performance measures is not a challenge unique to the Department of Defense. The Logistics Management Institute's Center for Public Administration conducted a symposium for senior financial managers in February 1995, where participants discussed many of the difficulties in developing performance measures. The missions of some federal agencies are harder to define than others. Further, some federal entities have nonfederal partners, such as state governments, who have control over outcomes. Finally, the complex nature of some departments, like Education or Health and Human Services, suggests that performance measures may be useful only at the lower levels of the organization.

The development of effective and useful performance measures is one of the most formidable tasks in implementing performance budgeting. Based on lessons learned to date,

the panelists suggested some characteristics of useful performance metrics:

The performance metrics ought to be integral to an organization's overall continuing process. The overall continuing process includes identifying goals, developing measures, gathering data, gauging performance, supplying data, and evaluating the organization's next steps.

The right measures should be selected early. Individual measures should be revisited and refined regularly.

There should not be too many metrics. Beware of becoming so enamored with performance measures that so many are developed that they become useless.

At the same time, a hierarchy of measures is needed that can meet a variety of management needs. Metrics should be developed that meet short- and long-term needs. A diversity of measures is needed to document performance, cost-effectiveness, and reliability.

Management information systems must be capable of producing the right kind of data. As the Program Analysis and Evaluation Directorate concluded in its analysis of the Defense Mapping Agency, an information system that can supply production and other data necessary to construct and interpret measures is essential.

MANAGERIAL IMPLICATIONS

Management needs to develop strategic and operating plans that are integrally linked to day-to-day operations. The strategic plan must include all stakeholders in order to be effective, and it must reflect a unity of purpose between the headquarters and the field that

comes from commitment on the part of top-level management.

Another management initiative that has worked well is the use of an activity business plan, which contains performance indicators and strategic objectives, in conjunction with the budget.

Adopting performance budgeting will require cultural changes among federal managers long accustomed to managing line items by appropriation. Top-level management support of the initiative is imperative. For performance budgeting to become an effective tool, however, managers must use the metrics produced as they make decisions on the allocations of resources.

QUO VADIS?

A central question is, How will performance budgeting be used in DoD? While the panelists did not address this issue explicitly, their comments suggest that performance budgeting for allocating resources among organizations represents a marked departure from historical practice, which has focused heavily on inputs. This approach almost certainly will demand a cultural change. Until that takes place, however, the real value of performance budgeting may be its use as a tool for internal management of resources and identification of mismatches between organization outputs and capacities and demands.

Beyond the matter of constructing such measures is the significant issue of whether federal government managers can shift away from traditional input-oriented methods of allocating resources toward using output-oriented metrics. ❖



Panel 3

Accountability and Results in Business Process Reengineering

Panel Members

Ms. Cindy Kendall
(Moderator)

Deputy ASD (Information Management), Office of the Assistant Secretary of Defense (Command, Control, Communications, and Intelligence)

Dr. David Chu

Director, Washington Research Department, RAND

Dr. Diane Disney

Deputy ASD (Civilian Personnel Policy), Office of the Undersecretary of Defense (Personnel and Readiness)

Mr. John Phillips

Deputy Undersecretary of Defense (Logistics)

Dr. Barbara Falkner

Director, Strategic Strike and Arms Control Division, Program Analysis and Evaluation Directorate, OSD

Accountability and Results in Business Process Reengineering

“*Efficiency gains from the new technology often can only be captured if changes are made in the structure of their organizations and the way they are managed.*”

President Clinton and Vice-President Gore
Technology and America's Growth

The panel on accountability and results in business process reengineering (BPR) was moderated by Ms. Cynthia Kendall, Deputy Assistant Secretary of Defense (Information Management). Joining Ms. Kendall on the panel were Mr. John Phillips, Deputy Under Secretary of Defense (Logistics); Dr. Diane Disney, Deputy Assistant Secretary of Defense (Civilian Personnel Management); Dr. Barbara Falkner, Director of Strategic Strike and Arms Control, OSD Program Analysis and Evaluation; and Dr. David Chu, Director of the Washington Research Department, RAND.

BACKGROUND

The goal of the DoD BPR program is to give managers a robust method for redesigning their functional activities to significantly improve effectiveness and efficiency. While BPR is an element of DoD's information management program and is frequently associated with information technology (IT), BPR has emphasized first redesigning functional activities and then applying automation to the redesigned processes. It focuses on redesign of all aspects of a functional process, not merely on automation.

Managers in many functional areas are reporting success in reengineering or redesigning their processes and some are reporting success

in implementing the redesigned processes. Yet implementation frequently has been difficult to achieve, and it often has been difficult to demonstrate the performance benefits that the proposed reengineered processes could achieve.

FOCUS OF REENGINEERING EFFORTS

Reengineering efforts are sometimes hampered by an inappropriately narrow focus, which can manifest itself in two ways. The first is an emphasis on automated information systems (AISs) or other aspects of IT rather than on the supported functional process. The second is a focus on a single functional activity without giving appropriate attention to other activities with which it is closely linked.

AIS vs. Functional Focus

An essential objective of reengineering is to redesign functional processes so that they save money. And even though the greatest potential for savings lies not in information systems but rather in reengineering the underlying functional processes, DoD has continued to emphasize detailed analysis of AIS costs rather than broadening the focus to fully encompass functional costs and benefits.

This narrow focus is found in the data requirements established by the Major Automated Information System Review Council (MAISRC), which calls for extremely detailed AIS cost projections but pays little attention to costs and benefits in the broader functional area. There are recent indications that progress is being made in this area; this momentum must be maintained so that MAISRC deliberations and other management forums can address the full impact of investment decisions that are placed before senior managers.

While AIS issues should not be allowed to “drive the train” in reviews and decision-making, technology is, in fact, very often the mechanism that enables dramatic improvements in both the cost and performance of functional processes. This challenge—ensuring that technology plays a key role in reengineering without becoming the sole focus of decisions—is one that must be met if reengineering is to achieve its full potential. Part of the answer to this problem lies in the area of performance measures, as discussed below.

Single Function vs. Cross-Functional View

Virtually every functional activity in DoD—as in any large, complex organization—has linkages with numerous other activities, and these cross-functional linkages can complicate the reengineering effort. One of the first steps in a reengineering project is to define the process that is the object of the reengineering. Care must be taken to ensure that related functional processes are identified and their linkages with the target process are well understood.

Challenges include dealing with the following types of situations:

Some functional activities have common data requirements (e.g., personnel management, payroll operations, and medical care) and should be engineered in a manner that capitalizes on opportunities for efficiencies, such as single data entry and shared use of data.

In many cases, *individual functional activities are part of an end-to-end process and must be engineered within that complete context*. For example, changes in the way doctors provide medical treatment that appear to make sense within the area of medical care might impair the associated pharmacy activity.

In some situations the *savings associated with reengineering are separated—either organizationally or functionally—from where the investment costs are incurred*, making it difficult to justify the investment. A real-world example was found by the Defense Investigative Service (DIS), which requested investments that would enable the agency to process security clearances significantly faster. While the investment costs would be incurred by DIS, virtually all the economic savings would appear elsewhere in DoD, as employees would incur less idle time waiting for security clearances.

To deal with these cross-functional issues, DoD managers know they must adopt what has been called an end-to-end process view or a systems view of their functional activities. As a means to this end, perhaps the existing DoD enterprise model should be enhanced. This model, which describes the generic activ-

ities performed within DoD, could enable managers to more easily identify related functional activities and the cross-functional costs and benefits of their reengineering initiatives.

ESTABLISHMENT OF PERFORMANCE MEASURES

Developing and applying performance measures is a prerequisite to achieving accountability and results in reengineering. As noted earlier, establishing the right performance measures can be an important element in ensuring that technology is treated as an enabler of BPR rather than as an end unto itself. Three actions are required:

- ◆ Performance measures must be established that are keyed to the interests of customers and other stakeholders. (A performance measure, or performance indicator, is the unit of measure that is applied to assess performance and to gauge progress toward established goals.)
- ◆ Specific performance targets must be established. (A performance target comprises the performance measure, a specific quantity or value, and a date by which that value is to be achieved. For example, a logistician might establish “order-ship time” as the performance measure; the associated performance target might be “to reduce order-ship time to 10 days by 1998.”)
- ◆ Information regarding actual performance must be provided to managers in a timely fashion to support critical decision-making events.

With the impetus provided by the Government Performance and Results Act and the National

Performance Review, many agencies are beginning to recognize customer surveys as a valuable tool. Such surveys can be used for a variety of purposes, including identifying meaningful performance measures, establishing performance targets, and measuring actual performance. One important caution: Customer surveys cannot be developed easily or casually, but require the application of both art and science if they are to be effective. If this caution is heeded, customer surveys hold great potential for supplying managers with useful information that will support them in planning and executing their reengineering efforts.

ROLES OF DoD COMPONENTS AND OSD PRINCIPAL STAFF ASSISTANTS

Since its inception several years ago, the Corporate Information Management (CIM) central fund has provided funds to support DoD components and principal staff assistants (PSAs) in BPR projects. DoD has recently decided to reduce the size of the central fund and require that managers requesting funds provide matching funding from their own resources. This decision will probably cause candidate reengineering projects to be subjected to more careful scrutiny before a component or PSA decides to undertake reengineering. The ideas described earlier could help managers deal with this added challenge. By structuring BPR projects with an end-to-end or system focus, and by establishing performance measures that can be used to demonstrate benefits in terms meaningful to their customers, managers should be better equipped to justify such projects and carry them out. ❖



Panel 4

DoD Privatization and Outsourcing: Toward More Implementation

Panel Members

Dr. John Christie
(Moderator)

Senior Research Fellow, Logistics
Management Institute

Mr. John Goodman

Deputy ASD (Industrial Affairs)

RADM (Ret) Dave Oliver

Director of Analysis, Electronic
Systems Group, Westinghouse
Electric Corporation

Mr. Sam Kleinman

Program Director, Center for Naval
Analyses

Dr. Myron Myers

Program Director, Logistics
Management Institute

DoD Privatization and Outsourcing: Toward More Implementation

“*Two major opportunities should be pursued aggressively: implementing the long-standing national policy of relying primarily on the private sector for services that need not be performed by the government, and reengineering the remaining government support organizations.*”

Directions for Defense, The Report of the Commission on Roles and Missions of the Armed Forces, May 1995

Dr. John Christie, Senior Fellow, Logistics Management Institute, moderated the panel on privatization and outsourcing. Panelists included John Goodman, Deputy Assistant Secretary of Defense (Industrial Affairs); Rear Admiral (Retired) Dave Oliver, Director of Analysis, Westinghouse Electric Corporation; Mr. Sam Kleinman, Program Director, Center for Naval Analyses; and Dr. Myron Myers, Program Director, Logistics Management Institute. After the panelists made summary comments, the floor was opened for discussion.

BACKGROUND

This panel focused on several factors related to implementing more privatization and outsourcing in the Department of Defense, as called for by the Commission on Roles and Missions of the Armed Forces. The panelists' remarks and subsequent discussion fell into two broad areas: the factors that must be addressed in implementing more privatization and outsourcing, and the strategies that should be considered in doing so.

FACTORS THAT MUST BE ADDRESSED

The Military Culture

Military personnel, long accustomed to government-run commissaries and medical facilities, will have less confidence in privately run operations. There is a concern that a lack of total control of resources will compromise readiness. There may also be an ego issue—that is, one's importance in the military typically is measured by the number of people controlled, not the size of the budget. Military commanders want people they know to run the process.

Laws and Legislation

A number of laws constrain DoD's use of more privatizing and outsourcing. For example, United States Code Title 10, Section 2465, prohibits the conversion of firefighting and guard services to contract performance. Section 2466 states that “Not more than 40 percent of the funds made available in a fiscal

year to a military department of a Defense Agency for depot-level maintenance and repair workload” may be contracted out. Restrictions on the amount of outsourcing that can be done at data megacenters were also mentioned.

Financial Incentives

Organizations pursuing outsourcing opportunities do not automatically benefit financially from such initiatives. Savings from outsourcing may be taken, for example, by higher headquarters to meet other unfinanced requirements.

Cost Accounting Systems

DoD accounting systems were not designed to track all the costs of in-house operations. For example, military personnel are considered a “free good” to organizations.

Contracting in the Public Sector

A major difference between public- and private-sector contracting is that all public-sector contracts must be open to all bidders, and unsuccessful bidders have the right to protest.

STRATEGIES FOR PROMOTING OUTSOURCING

One of the goals should be to promote more interaction between the military and civilian sectors, in order to make maximum use of specialized and available expertise. At the same time, we must understand why some functions are inherently military and make no sense to contract out. In any case it is helpful to have group consensus that change is necessary.

Incentives

The current practice of siphoning savings from local commanders to pay for other higher headquarters bills needs reexamination. Allowing local commanders to retain a percentage of the savings for reinvestment in other initiatives would be an effective incentive. Permitting “reprogramming” of funds across appropriations (e.g., using savings in the operations and maintenance appropriation to pay for construction of new facilities) would also motivate local commanders.

Contractual Initiatives

A number of initiatives are aimed at changing the current contractual climate to make it more conducive to outsourcing. Source selection is chief among these initiatives. Historically, the government has chosen sources on the basis of low cost. In pursuit of outsourcing, the government should consider basing its choice on “best value.”

Five Key Contracting Elements

1. Defining and specifying the work to be accomplished
2. Identifying the best acquisition strategy to pursue
3. Laying out key contract terms and conditions on disputes and incentives
4. Determining how sources are selected
5. Addressing contract administration

The panelists discussed the need to move toward performance-based statements of work, focusing on outcomes and not the inputs. Most DoD work statements specify in minute detail precisely what maintenance steps must be taken on each piece of equipment and when. Policing requirements are burdensome and costly. Besides, performance-based work statements encourage the offer of commercially available goods and services that meet the need without necessarily conforming to detailed specifications. The panelists urged the establishment of “tiger teams” to do performance work statements.

The panelists also discussed establishing a central clearinghouse to assist local contracting offices in writing outsourcing contracts. Particular emphasis should be placed on maintaining quality and top-notch performance and constructing appropriate incentives for contractor performance. The General Accounting Office and the courts are more and more favoring this approach, in which technical and performance considerations and past performance are factors in source selection.

Organizations must also retain the capability to understand, process, and manage different kinds of contracts.

Human Resource Planning

The needs of all personnel—both military and civilian—need to be considered. One panelist pressed DoD to continue its early retirement program and separation incentive programs for all employees affected by outsourcing. A symposium participant urged the careful and deliberate consideration of the civilian workforce in making decisions to outsource.

Revisions to OMB Circular A-76

The panelists proposed consideration of several revisions to the cost comparison process. For example, removing the 10 percent advantage accorded the in-house organization would level the playing field, as would requiring the military services to conform to federal acquisition regulations and cost accounting standards as commercial firms must.

Requiring in-house winners to sign a contract agreeing to performance standards and further requiring them to re-compete after three to five years would help ensure effective performance on the part of the government unit. There was also some discussion of the development of most efficient organizations (MEOs) after the requests for proposals are sent to industry, to remove the advantage that has been historically accorded to the public organization. ❖



PANEL PROCEEDINGS

Panel 1

Pricing Goods and Services in DBOF

MR. MILT MARGOLIS

Senior Fellow, Logistics Management Institute

Mr. Margolis opened the panel discussion. He contrasted the pricing policies of large corporations with those of the Department of Defense. Customer organizations in large firms can buy services from corporate service centers or external sources. Service centers, likewise, can produce services internally or purchase them from outside the firm. Pricing mechanisms must be established that reflect marginal costs so that decentralized decision-makers make decisions that are optimal from the corporation's perspective. These mechanisms have proven very effective in reducing overall costs. The Department of Defense's break-even policy, as currently implemented, does not approximate a marginal cost pricing strat-



egy and hence does not contribute to reducing DoD's costs of services.

Mr. Margolis posed several questions to consider:

What, if any, are the shortcomings of the Defense Business Operations Fund (DBOF)?

What DBOF modifications could enable DoD to reduce the cost of acquiring the goods and services it needs to perform its mission? Can a market system be established to enhance achievement of that goal?

How do we set up a market system in DoD to achieve efficiency?

MR. JOHN BEACH

Principal Deputy Assistant Secretary of the Air Force
(Financial Management and Comptroller)

Mr. Beach reviewed the origins of DBOF. He indicated that it was established in a Defense Management Review Decision (DMRD) on February 2, 1991. When established, it was expected that, under DBOF, customers and suppliers



would have a better price mechanism and that the relationship between costs and outputs would be stronger. Further, all support activities were to be brought under DBOF.

Mr. Beach asserted that DBOF has not lived up to these expectations. It has turned out that depot maintenance, supply, and transportation have worked out relatively well. Some current problems are resulting because the Department tried to incorporate too much, too soon into DBOF.

Further, DBOF uses a price mechanism where the rates are set to recover funds. These kinds of rates, however, do not reduce costs, and the rates are fixed for long periods and well in advance of when costs are incurred.

Mr. Beach discussed several differences between economists and “budgeteers.”

Price flexibility. Economists argue that price flexibility allows customers and suppliers to behave more rationally. Budgeteers argue for stabilized prices or rates, set 18 months in advance to allow customers to know what prices will be.

Centralization versus decentralization.

Economists assert that prices and rates should be established in a decentralized manner, further suggesting that it is difficult to control rates and prices inside the Pentagon. Budgeteers argue that if rates are set centrally, then it is easier to develop the budget. Mr.

Beach mentioned that he does not see plans to decentralize price setting.

Market choices. Economists state that customers should have economic choice and the possibility to substitute. Budgeteers argue that customers do not have choices; choices, in fact, are made through Program Budget Decisions.

Mr. Beach offered several thoughts on how to improve DBOF:

- ◆ Total costs for indirect items cannot be included in rates charged to customers. DBOF does this now, and this adversely incentivizes customer behavior.
- ◆ Cost definitions that DoD uses do not give full visibility to costs incurred. The department does not have a cost accounting system that provides such information.
- ◆ In 1991, a proposal was made to make DBOF interdepartmental and inter-agency, with rates set much as they are at large utility companies. Rates need to cover costs and be kept current.
- ◆ We need to examine activities where we can move away from stabilized rates.

DR. CRAIG COLLEGE

Chief, Force and Infrastructure Cost Analysis Division,
Program Analysis and Evaluation Directorate, OSD

Dr. College offered two principles that seem to underlie the implementation of DBOF:

- (1) Establishment of market structures so that suppliers and customers would face costs related to their sale and purchase of goods and services within DoD and thereby provide



additional information to create cost-reducing exchanges. (2) Incorporation of a break-even constraint so that individual business areas would be fully funded and, in the aggregate, DoD top lines would not be violated.

He asserted that there are two components of DBOF prices: direct costs of the service or good, and a “tax” component to handle other pieces of business activity. He commented that customers (e.g., program managers of weapon systems), when confronted with improper prices, may not make the cost-minimizing decisions that top-level decision-makers would make for the good of DoD. He asked, “If customers cannot make cost-minimizing decisions on behalf of DoD, have we set up DBOF correctly?”

Dr. College posed two further questions:

Does it make sense for a commander in the field to subsidize DBOF activities unrelated to his service or good?

How can we separate direct costs from indirect costs, and then set prices wisely?

Dr. College then touched on two areas of DBOF that make it difficult to answer many programming questions.

Enhanced formats in the Program Objective Memorandums (POMs) for expected DBOF activities, revenues, and costs are needed. If we had a better view of future business levels, then DBOF activities could program for

downsizing earlier. This has an impact outside DoD, since private businesses look to the future to see where their markets are headed.

The Future Years Defense Plan (FYDP) data for DBOF are difficult to use for programming. DBOF is straightlined in the outyears, and there is no mechanism within the current FYDP structure to learn where DBOF revenues originate. A lot of inter-organizational transfers occur. A simple adding up of the DBOF program elements grossly overestimates the size of the DBOF world, because these transfers are not evident in the FYDP (but are buried in the program elements) and are little more than transfers of obligational authority and not mutually exclusive resources.

Dr. College then concluded by saying that the economic approach to DBOF is not greatly at odds with a financial approach to DBOF. Incremental changes could bring them closer together, if DoD financial data systems could be modified so as to generate the marginal costs of internally produced inputs, and if the costs of nonmarketed outputs and fixed costs are charged by fixed fees levied directly on operational commands and other user units rather than included within the prices of individual goods and services.

Ms. JOAN FREEMAN

Resident Fellow, Logistics Management Institute

Ms. Freeman commented that she worked on the original DBOF DMRD. She asserted that DoD did not know all the answers, but wanted to examine the possibilities.



sions, and that we must continue to press for improvements.

Ms. Freeman touched on several pricing issues.

She emphasized that the focus must be on the costs of organizations' operations. She commented that if DBOF did not exist today, we would still be having similar discus-

With respect to the break-even policy, when we incur losses, then we adjust future prices, and prices are based on current cost and past loss. How do we fix this, or do we fix it?

How can we better use business techniques for business-like activities?

How can we best price and manage activities, goods, and services? At the headquarters level? At the activity?

Do we have the staff to manage a more complex pricing structure? Expertise is needed at lower levels, not just at the headquarters.

With regard to policy and enforcement mechanisms, if people do not like our pricing poli-

cies and find a way to circumvent them, should we not reexamine the policies to determine whether they are the right ones and ones that we are willing to enforce?

Can we develop systems to support complex pricing mechanisms?

The Defense Logistics Agency has made a number of improvements in pricing, and other agencies may have done so, too. Overall improvement will require many “baby steps.”

BILL COONCE

Director, Revolving Fund,
Office of the Under Secretary of Defense (Comptroller)

Mr. Coonce noted that DBOF is not new. The Department has had revolving funds and stock funds for years (at least since the 1940s). DBOF’s problems have been around for years.



DBOF does many things that private business would not because of low volume, and some theoretical economic constructs proposed for DBOF are not easily applied.

Mr. Coonce also noted that DBOF has tried to incorporate all costs of goods and services into prices. As DBOF has progressed, much change has occurred in DoD: enormous downsizing that could tend to mask DBOF’s potential benefits.

Stabilized rates mean that savings cannot be passed on to the customer in the current year.

DoD is risk-averse; in businesses, higher risks can be assumed.

He outlined several factors that suggest the department cannot be considered a business from a purely theoretical economic construct.

The department has a warfighting mission; commercial businesses do not. The Commanders in Chief (CINCs) are users in many respects, but are not paying customers. Mr. Coonce hypothesized that maybe the department does not want CINCs worrying about buying goods.

DBOF consists of large organizations, many of them high-technology, with great capitalization, such as shipyards. In this environment, it is difficult to develop free competition quickly.

He suggested that while DBOF is not a perfect pricing mechanism, it does provide some economic incentives for customers.

He mentioned that the department needs a good cost accounting system.

Mr. Coonce concluded by asking whether DBOF should be a direct appropriation, or whether it contributed to overall DoD effi-

ciency in attempting to apply general economic theory in an imperfect environment. Since DBOF is not a perfect economic structure, it should not be forced to adhere to strict economic goals or expected to exactly follow all rules of economic theory.

DR. BILL ROGERSON

Professor, Department of Economics, Northwestern University

Professor Rogerson presented a briefing on his analysis of the use of transfer prices within the Department of Defense.



Dr. Rogerson began by reviewing the role of transfer prices within organizations. He stated that the problem consists of asking users to be aware of internal prices relative to external prices, motivating users to make efficient usage decisions, and motivating suppliers to be efficient. He has concluded, as have many other professional economists and “real-world” corporations, that the solution to these problems lies in the use of transfer prices, in which the prices of internally supplied inputs are set equal to the cost of producing them.

Professor Rogerson then discussed how prices should be set. A central point is that in order for military units to make correct usage decisions, the price of each internally supplied input must be set equal to the cost of producing it. The main goal of DoD, however, lies in the break-even principle, in which a service center must identify products and charge prices for them so that its revenues equal its costs. This creates a “neat and tidy” funding system. Common errors are attempting to recover the cost of nonmarketed outputs by charging more for marketed outputs, and

devoting insufficient attention to correctly allocating costs between marketed outputs. Both errors can be corrected without violating the break-even principle.

Professor Rogerson then focused on depot-level reparables (DLRs) as a case study. In his view, service centers provide two services: furnishing access to and maintaining inventories, and arranging a repair or replacement if the military unit decides not to repair the DLR itself. The supply system consists of two actors: central logistics, the owner and maintainer of all inventories and the intermediary between military units and government-owned repair depots; and government-owned repair depots, which repair broken DLRs submitted to them by central logistics. The costs of the supply system break down into three categories: depot repair, replacement, and central logistics. Depot repair costs represent about 50 percent of the total costs, replacement costs about 25 percent, and central logistics costs about 25 percent.

The central question then becomes: When a DLR malfunctions and is removed from the aircraft, should the military unit repair the component itself, or should it turn the broken unit over to central logistics for repair?

Professor Rogerson then described the historical policy, in which no transfer prices are used in the relationship between military units and the supply system. The supply system was directly funded through appropriations. Military units requisitioned services from the supply system as necessary. A set of regulations described, at least in theory, how users should decide the location of the repair. The problem is that regulations could not consider all possible situations and how circumstances might vary from base to base. Further, in all likelihood, the location of the repair decision was often being made incorrectly.

Dr. Rogerson described the current Air Force policy, in which the supply system was turned into a service center operating under the break-even principle. The supply system no longer receives direct appropriations from Congress. Rather, it charges military units prices for marketed outputs. Marketed output is repair or replacement of DLRs. The same price is charged for all items within each DLR type.

Under this policy, if a military unit repairs a broken DLR itself and then returns it to the inventory, it pays nothing to central logistics. If the military unit returns the broken unit to the inventory and asks central logistics to arrange a repair or replacement, then it pays central logistics. The effect of this new policy is that more repairs are being performed on base—perhaps too many, relative to what would minimize costs for the Air Force as a whole. The reason for the problem: the Air Force has set the wrong prices.

Professor Rogerson then described three kinds of pricing errors.

Access to inventories. The supply system produces two types of outputs for military units: inventory maintenance, and repair or replace-

ment. It charges only for repair or replacement. Under the break-even principle, all costs of inventory maintenance are allocated to repair or replacement. Prices should be 27 percent lower, the portion of supply system costs that central logistics represents. Professor Rogerson suggested that the best alternative is to charge military units a fixed annual inventory maintenance fee based on the number of DLRs they employ.

Repair versus replacement. The same price is charged for a depot repair as for a replacement. The location of repair decision is distorted because an extra fee to recover replacement costs is added to all depot repairs. The prices of depot repairs is 23 percent too high, the portion of supply costs for replacement. Professor Rogerson would advocate charging military units a fixed annual replacement fee based on the number of DLRs they employ.

Degree of difficulty of repair. The supply system charges the same price for an easy repair as for a difficult one. The price of an easy repair is too high, and the price of a difficult repair is too low. Military units find it profitable to perform easy repairs on base, even if they could be accomplished more cheaply at the depot. Since informational requirements to keep track of actual costs incurred on each DLR are extremely large, a reasonable alternative would be to determine the severity of the problem after an initial inspection and charge on that basis.

In conclusion, Professor Rogerson stated that too many repairs of all types are performed on base, especially those of below-average difficulty. The solutions include charging for costs of production of nonmarketed outputs and fixed costs by fixed fees levied directly on operational commands and other user units, and improving information systems so that variable costs can be allocated more accurately.

Some lessons for DBOF pricing emerge from this analysis:

- ◆ Internal transfer prices can be used to decentralize usage decisions that military units make for internally supplied inputs.
- ◆ In order for military units to make correct decisions, the price of each internally supplied input must be set equal to the cost of producing it.
- ◆ Common errors include trying to pay for the cost of nonmarketed outputs by charging more for marketed outputs, and devoting insufficient attention to correctly allocating costs between marketed outputs. Both errors can be corrected without violating the break-even principle. ❖

Panel 2

Performance Budgeting in Defense Agencies

MODERATOR: IRV BLICKSTEIN

Director, Acquisition Program Integration (API), Office of the Under Secretary of Defense for Acquisition and Technology (USD[A&T])

Mr. Blickstein opened by addressing the problem of forces versus infrastructure. He mentioned the project at the Logistics Management Institute focusing on using investment to reduce life-cycle cost in the field and in the fleet; the Cost-Performance Integration Process Team that is building requirements in the DoD 5000 acquisition process; and Program Analysis and Evaluation (PA&E) work on improving the Visibility and Management of Operating and Support Costs (VAMOSOC) system and collecting data from the field. Overall, his office is pushing very hard on the question of how to reduce cost.

Mr. Blickstein suggested that one of the ways to consider costs is to examine the defense agencies. From 1980 to 2000, the defense agency Total Obligational Authority (TOA) equates to almost 10 percent of DoD TOA.

Mr. Blickstein mentioned that two different reviews of defense agencies have been conducted this past year: (1) the A&T/API and



Joint Chiefs of Staff (JCS) review in May, which cuts the defense agencies in FY 1997 and FY 1998 by \$1 billion or less each year, and (2) the PA&E program review this past summer.

He then showed an organizational diagram of the defense agencies highlighting the combat support agencies. The budget of the defense agencies was shown individually to bring out the magnitude of their funding level.

Mr. Blickstein then posed two essential questions before beginning the panelists' discussions:

Can we measure the combat support agencies with performance budgeting?

Is performance budgeting a good management tool? If it is as good as the budget process, then we should use it. Performance measures used by the Comptroller for PBDs can then be used internally to justify our programs.

MR. RICHARD KEEVEY

Defense Finance and Accounting Service (DFAS)

Mr. Keevey began by discussing the slogan on the DFAS logo: “Service to the Customers, Support to the People, and Savings to the Nation.” The latter element, “Savings to the Nation,” is what DFAS focuses on for productivity measures.



By way of background, Mr. Keevey mentioned that DFAS was created 40 years ago, now has 25,000 employees, and accounts for and disperses the \$250 billion DoD budget. Each month, it also pays 2 million invoices, makes 10 million payroll disbursements, disburses \$25 billion, and issues 40,000 reports. It does not have any specific earmarked productivity program, but productivity is built into everything DFAS does. Customers demand productivity, and the remainder of Mr. Keevey’s discussion focused on how DFAS meets that demand.

Mr. Keevey discussed the effects of the DoD downsizing—what is happening and what has occurred. From the time DFAS was established and adjusted for subsequent events that brought more people into the organization, there were about 30,500 people, whereas today it has about 24,700 employees. He showed that trends point toward continued downsizing, which is no different from other trends in the DoD. Cost trends are also downward. The budget is under \$1.65 billion today, and the trend is going down, but in comparing prices he noted the fluctuations given the vagaries of DBOF pricing. Mr. Keevey then noted that it costs 0.7 percent of the DoD budget to provide finance and accounting services to DoD.

DFAS has a number of initiatives under way to be more productive and reduce cost. The first one is a major consolidation effort.

Initially, DFAS had 6 large finance centers and about 330 finance and accounting offices throughout the United States. The DFAS goal is to reduce to 5 major centers (this has already been accomplished) and 21 or fewer operating centers (currently, there are conflicting directions as to the actual numbers). About one-third of the finance and accounting offices are already closed. This year, DFAS will close another 90 offices. Mr. Keevey pointed out that this is a complicated move, since DFAS is closing down and transferring work on bases and installations where unit commanders were comfortable and familiar with the operations.

As part of the overall transfer, DFAS requires a 15 percent personnel reduction as they move into the operating locations. Mr. Keevey indicated that there have been some successes and some problems, the most pressing of which involve an inordinate number of backlogs. DFAS did not properly strategize when it closed some operating locations and moved into the new ones, thus resulting in backlogged vendor payments and travel reimbursement. Failing to properly space the shutdowns caused four to five months of unnecessary problems. DFAS is now conscious of this problem as it moves into the next stage of consolidation. This is one of the most important areas of productivity improvements; instead of doing business in 330 locations, DFAS will now operate in 21 or fewer. Mr. Keevey explained the glide path of the consolidation schedule.

He described how DFAS seeks to improve performance: reduce standardization of systems, eliminate personnel required to maintain redundant systems, and replace inefficient systems. Previously, there were 250 different finance and accounting systems (payment systems, payroll, transportation payments, accounting systems, and other systems serving as books or records). The goal is to reduce and improve those systems, which will lead to productivity improvements (which result in fewer systems to maintain) and better outputs from the improved systems.

Mr. Keevey then indicated how changes in the system are expected to improve productivity.

Defense retiree and annuity systems. Previously, 2 million retirees were tracked with 8 different systems in 4 sites; now there is 1 system at 2 locations. DFAS used to handle 2,500 accounts per employee; now that figure is up to 3,600 per employee and is expected to top out at 3,700 or 3,800 by 1997. The savings from installing this system on an annual basis is about \$10 million out of a \$65 million operation.

Payroll. The civilian payroll is about 800,000 civilian employees in DoD. There were 28 payroll systems initially; today there are 9; the goal is a single system by April 1997. Similarly, there were 351 payroll offices; the goal is 4; so far, 220 payroll offices have been eliminated. These initiatives have saved \$80 million annually.

Business process reengineering (BPR). According to Mr. Keevey, BPR will eliminate redundancies and install more productive business practices. Mr. Keevey described the endeavor under way on the A76 process in debt management, administrative facilities, and logistical management support. After this effort is complete, DFAS will subject other areas to the

rigors of the A76 process. DFAS expects a 20–40 percent reduction in cost using the A76 process.

Initially, 70,000 pages in 360 different manuals dealt with finance and accounting regulations in DoD. This is being reduced to a single financial management regulation in hypertext on compact disk/read-only memory (CD-ROM) in 15 volumes (13 have been completed to date).

Mr. Keevey stated that DFAS must be able to interact well with the personnel community as well as the acquisition and logistics community. A number of studies and teams are working now to address the relationships between these communities.

Unmatched disbursements and negative unliquidated obligations are the problem areas. Systems were not designed properly from the outset to deal with these issues. Payments were made before the accounting systems were checked, and payment offices were separated from the accounting offices. A large-scale project under way with the acquisition community is building a shared database to ensure proper matching of documents with one input required; the project is scheduled for completion in 2002. However, some improvements have already been made. For example, 20 years ago there were problems with disbursements amounting to about \$50 billion per year, and that figure is now down to about \$19 billion.

Another area of improvement is in garnishments. Mr. Keevey mentioned that DFAS now processes about 8,500 new garnishment cases per month. This operation has been consolidated into one site and handled by one system. He also pointed out that investing \$5 million in imaging would save \$19 million over the next 5 years. Today, he said, paper

drives the DFAS; technology to eliminate data entry and reduce reliance on paper must be the solution in long run.

Mr. Keevey then discussed electronic commerce and electronic data interchange (EC/EDI) and the linking of payment systems and accounting systems to limit improper payments. He called for an extension in the use of electronic funds transfer for contract and other vendor payments, and mentioned that imaging is the solution to the paper problem.

He said that internal controls must not be compromised in order to achieve increased productivity. For example, there is a potential cost associated with speeding up payments (e.g., improper or duplicate payments).

Mr. Keevey then described how managers are kept informed in DFAS. Monthly reports cover 136 performance measurement indicators; 48 are used at top levels to provide a thumbnail sketch of performance.

MR. ROGER SPERRY

National Academy of Public Administration (NAPA)

Mr. Sperry introduced NAPA as a nonprofit, nonpartisan organization chartered by Congress.



NAPA's president, Mr. Scott Fosler, met with the Senate Budget Committee in January 1995 to discuss how to get performance information into the budget process. Mr. Sperry stated that the current budget process focuses on allocation of dollars, people, supplies, and equipment. It does not focus on accomplishing results, mission, outputs, outcomes, and impacts. Unless specific action is taken to shift the emphasis toward performance, the resource-driven nature of deficit reduction will reinforce this orientation toward inputs. He described the current situation as one of moving from measuring inputs to analyzing outputs.

Mr. Sperry described pilot programs initiated under the Government Performance and Results Act (GPRA) of 1993 and discussed NAPA's efforts to develop criteria to assess performance measures.

He described the challenges to full implementation of performance budgeting and touched on acceptance of rational management and analysis at the political level; several measurement issues; and honesty in reporting the results. He focused on several measurement issues, including clarity and measurability of goals, getting data and paying for it, avoiding unintended consequences, timeliness and relevance, and complexity.

Mr. Sperry then reviewed the importance of setting national goals, using the Global Positioning System as a case study.

He then discussed the development of performance measures for information systems. Performance measures, he said, must fit into the overall continuing process, which includes identifying goals, developing measures, gathering data, engaging performance, supplying data, and evaluating next steps. Individual measures should be revisited and refined regu-

larly. The organization should have a limited number of performance measures that are relevant, simple, timely, valid, useful, and used. It should aim for a hierarchy of measures; a mixture of short- and long-term measures; a diversity of measures to produce multiple pieces of evidence of performance; cost-effectiveness; reliability; the ability to calculate at the right interval to update needed performance information; and usefulness at the level involved for making decisions. The ideal would encompass effectiveness and efficiency, a bal-

ance among measures to address achievement of strategic goals and priorities, customer satisfaction, operational quality and productivity, opportunity for long-term learning, and innovation—a balanced scorecard.

Mr. Sperry asserted that DoD has made some progress in performance budgeting, but there is still a long way to go and challenges lie ahead. The jury is still out on whether this will become the predominant way of doing business in the government in the years ahead.

REAR ADMIRAL (SELECT) JUSTIN D. MCCARTHY

Defense Logistics Agency (DLA)

Admiral McCarthy stated that DLA is conducting one of the pilot tests called for by the GPRA. He asserted that DLA cannot yet claim victory, but it has made significant progress on the learning curve. To provide context, he outlined DLA's principle business areas and related that its revenues of \$14 billion would place it at Number 36 on the Fortune 500 list. In terms of the number of employees, DLA would be Number 72 on the list.



Admiral McCarthy then focused on two of the main “businesses” in DLA: inventory management and distribution. DLA is most mature in these two areas with respect to performance-based budgeting.

He presented DLA's experience in performance-based budgeting by outlining three periods of development.

THE EARLY 1980s

During the early 1980s, DLA principally operated in a “stovepipe” environment. The business areas were organizationally and functionally operated independently of each other. Budgets were built independently, and there was very little integration between business areas across the organization. For example, events happening in distribution were not necessarily coordinated with the supply business area, or even seen as affecting supply. Business decisions tended to precede any analysis of the funding implications.

Performance measurement was largely limited to monitoring performance against DoD standards, with little focus on cost reductions. Customers were not thinking about cost, mainly because costs they were seeing were

purely the materiel and materiel-related costs. The customers were not seeing the operational and overhead costs, because these costs were funded by appropriated funds and were not included in the prices customers were paying for materiel. Workload data, to the extent it was monitored at all, was used largely in response to staffing questions rather than cost issues.

In budget discussions, priority was given first to defending existing baselines and then to pursuing funding increases to support new initiatives.

THE EARLY 1990s

In the management vernacular, DLA had a “significant emotional event” in the early 1990s as a result of two dramatic changes in the way it did business: the Defense Management Review Decision (DMRD) process, which significantly expanded DLA’s business base (the most significant of which was DMRD 902, which consolidated wholesale distribution functions in DLA); and the creation of the DBOF, which took operating costs formerly funded by appropriated sources and moved them into DLA rates, giving customers visibility of the overall cost of operating DLA.

This change meant that actions in one business area could be linked to another business area. This, in turn, caused DLA to begin looking at the impact of decisions in one business area on other business areas. Cost implications could now be linked to business planning evolutions. Performance measures were now shifting to productivity. Customers were now seeing prices that more closely reflected the total cost of the support being provided. As a result, concerns over prices began to surface, and DLA started to advertise what they were doing to market what the customer was

getting, as compared to what the customer was paying.

The shift to DBOF also shifted the focus to unit cost. However, unit cost was used principally not as a cost-reduction mechanism but as a vehicle to achieve full funding (i.e., the total funding required was divided by the anticipated workload to yield the unit cost required to fully fund operations).

Cost allocation issues were starting to surface at this time. Operating costs became a big factor in looking at how DLA built prices and determined what costs to include. A question that surfaced was how to treat the costs of headquarters. Were they to be distributed to the various business areas or not? If they were, what was to be the basis of allocation?

THE MID-1990s

In the last five years, DLA’s incorporation of performance-based budgeting has matured significantly. DLA is now talking and thinking like a corporation instead of a series of individual business units. At the strategic level, DLA has developed a strategic plan that is an integral part of the day-to-day decision process, in contrast to the past, when the strategic plan was a separate document developed in isolation and then largely placed on a shelf. Today, the strategic plan is integrally linked to daily management decisions. Managers now monitor performance in terms of its contribution to the strategic plan. Performance is now linked to the commitments made to customers.

DLA discovered that too much of its performance-based analysis was down at the “tactical level” and concentrated on measures the customer cared little about. DLA started to ask questions regarding what the right measures are. From the customer’s perspective, DLA

needed to shift its attention to customer focus areas such as timeliness, quality, and affordability. With this in mind, DLA then had to determine how to effectively measure these factors.

It turned out that no management tool existed to measure the items that the customer cared most about. In some cases surrogates existed, such as Quality Deficiency Reports and Receipt of Item Discrepancies, but very few customers provided DLA with feedback on these vehicles, so they did not represent what the customers really thought about quality.

Thus, DLA created new measurement tools. One is called the Nielson Rating System, where DLA proactively goes out to a selected group of customers and asks for inputs on quality, timeliness, and affordability. Another such tool is a measure of total logistics response time from requisition submission by the customer to receipt by the customer. DLA is also working to finalize an effective “market basket” analysis tool to compare prices to the private sector where possible.

Admiral McCarthy pointed out that one of the principal tools that enables DLA to link performance measures to the budget is an activity business plan, which is negotiated with the field activities. Performance goals are set in these business plans, which directly link to the corporate strategic plan and, in turn, drive the resources required to fund the activity in accomplishing its performance goals. DLA currently has a business process reengineering effort under way to further refine and strengthen this performance-based budgeting tool.

Admiral McCarthy reiterated that a significant cultural change has taken place at DLA. It

thinks about things differently than it did a couple of years ago. It now functions as an integrated corporation that sets and achieves customer-driven performance targets. The use of the strategic plan is an integral part of this cultural change.

Admiral McCarthy emphasized that this cultural change would not have been possible without top management commitment. DLA has had the benefit of such a commitment. Admiral Ed Straw, the director of DLA, was the catalyst for the change, supported by a management team that was ready to make the transition. The transition has been aided by the private sector in providing benchmarking opportunities to help DLA focus on areas where it could improve performance measures. Admiral McCarthy also mentioned that DLA's progress is being recognized in the private sector, as evidenced by the fact that it was recently approached as a benchmarking candidate by a major oil company.

Admiral McCarthy concluded by summarizing what DLA has discovered are the “must haves” to support a transition to performance-based budgeting: strategic focus from a stakeholder's perspective; unity of purpose between headquarters and field activities; top management commitment; measurable and manageable performance measures; refined skills in economic and return-on-investment analysis; and integration of budget and functional perspectives. He cautioned against becoming so enamored with performance measures that so many are developed that they become useless. The right performance measures must be selected early so that necessary data can be gathered. This is a difficult challenge. He also encouraged those embarking on performance-based budgeting initiatives to obtain assistance from the private sector.

DR. DAVID McNICOL

Deputy Director (Resource Analysis),
Program Analysis and Evaluation Directorate, OSD

Dr. McNicol opened by suggesting that his was a view “from the trenches” in an organization that uses budgets rather than formulating them. During the last programming review cycle, PA&E started to review several defense agencies. Secretary Perry liked the idea so much that he added additional defense agencies, for a total of 10. The defense agency review was kicked off in February with a conclusion planned for July or August.



Early on, discussions arose about what methodologies to apply but did not resolve the issue. The analysis was organized into two phases: describing the defense agency and learning what it does, who the customers are and what the costs are; and identifying issues as nominated by OSD or the agencies themselves. After the review got started, PA&E “backed into” a technique like performance budgeting as an approach to reviewing the program. The Defense Investigative Service (DIS) and the Defense Mapping Agency (DMA) both illustrate this approach.

Dr. McNicol elaborated on DIS. When his office first met with DIS representatives, the DIS POM was still several weeks away from completion. The DIS position was that its program was underfunded in the outyears. DIS pointed to the Case Completion Time (CCT) that it was going to send forward in the POM. The CCT in 1995 was about 170 days. Dr. McNicol suggested that symposium participants view this from the perspective of a prospective new hire. If it is November 30 and a graduate of the following June’s univer-

sity class is sought, it is 7 months until the new hire wants to come on board and 6 months for the necessary security clearance. If the CCT goes up to 260 days, agency heads need to have people that they want to hire wait 4 to 5 months

after they graduate to put in the security clearance.

DIS was saying, from the point of view of the managers, that CCTs were badly out of hand and that it would be irresponsible to cut funding and impose staff ceilings that required reduction of agency staffing. The consequences of those two actions—cutting resources and cutting staff—would result in big increases in CCT. When questioned, DIS indicated that the requirements program had changed: top secret investigations are more complete now than before, and periodic reinvestigations more frequent. Thus, DIS stated that the demand for its services had increased and staffing had decreased, resulting in the growth of CCT.

These two facets—the staff decreases and the requirements increases—have different implications. Requirements increases are something we do to ourselves, and we can ask whether, given the choice between adding staff or requirements, the right choice was made. What was done next was to separate these two inputs, requirements increase and staff decrease.

Dr. McNicol’s staff tended to doubt that the staff decreases were really what was driving increased CCT. Over the years of the FYDP,

DIS projected its workload in each of several categories to be declining very sharply. The management information system (MIS) at DIS was consulted to obtain further insights. However, data were not available to separate requirements-driven effects from cost changes. The MIS did not allow managers from the DIS sufficient visibility into what was driving the CCTs. Apparently the DIS used CCTs as red flags to obtain top management attention. Alternatively, a cynic might view it as an advertising device. The truth, Dr. McNicol indicated, was probably a combination of both.

DIS forecasted workload for its upcoming POM. In addition, the PA&E analyst working on Dr. McNicol's staff obtained relevant times required to do each of these cases. It became a simple matter to weight the projected cases by the relative times to obtain the average number of closed cases per work year. Staffing is not the main factor in driving up the CCTs. Changes in requirements appeared to be the cause of the CCT increase; however, there are a couple of problems with that premise. Requirements changes occurred primarily in 1992 as well in 1991 and 1993. That is not the pattern that would be expected over time. If, over time, requirements changes were driving the CCTs, the expected shape would be more like that of a step function. But the CCTs increase over time, so the numbers did not work out quite right. The PA&E analyst discussed extensively with DIS steps taken to improve productivity, in particular the major automation efforts.

The PA&E analyst developed her own metric, which used weighted cases closed divided by work years to measure projected productivity. DIS provided good rationale as to why initially, with the introduction of automation, there is a decrease in productivity. In terms of the pre-POM data, productivity climbs but never

reaches the 1994 level, and productivity ultimately drops in the outyears. DIS managers were asked whether this pattern was reasonable in terms of the productivity levels expected and they responded that it was not.

It turns out that this pattern was a consequence of other management decisions that they had not recognized but that affected the productivity projections. DIS had not looked at the problems to establish the outputs, the inputs, and the productivity of the staff. DIS went back and revised some numbers for the POM for a more reasonable trend in productivity. The line showing the POM data is not something we want to advertise as a great success story, but it is a step in the right direction.

The analysis had two consequences. There were no overguidance requests to resolve CCTs during the POM, and the "hump" in CCT was judged to be between tolerable and manageable.

Productivity-based budgeting really works because it directs managers to consider the following:

- ◆ What are the outputs of the organization in question?
- ◆ What are the inputs?
- ◆ What is the relationship between the outputs and the inputs?
- ◆ Who is buying the outputs? Do they like them? If not, what are the alternatives?

This is a very straightforward, standard format and one that lends itself to analysis.

Dr. McNicol wrapped up this portion of his briefing by noting that some defense agencies

argue that they are too big or too complicated to measure the outputs. He invited the skeptics to investigate what is being done in the private sector. He cited the example of a mining company that possesses a mathematical model that extended from the geology of its individual mines. For any organizations that do not have performance budgeting, it is not that they cannot budget in terms of performance but simply that they have not tried.

Dr. McNicol concluded his presentation by examining a sample of 12 defense agencies or field activities. He briefly reviewed each to determine which are likely candidates for performance budgeting and, for those that appear to be good candidates, where they stand on implementation. That review is summarized in Table 1. Among defense agencies, performance budgeting falls somewhere between an idea that we are busy pursuing and one that we are already doing. ❖

AGENCY/ACTIVITY	CANDIDATE?	COMMENT
Advanced Research Projects Agency	Unlikely	One does not know whether the agency has done a good job until many years down the road
Ballistic Missile Defense Office	Probably not	Essentially a big program office
Defense Commissary Agency	Yes	Not aware of any progress
Defense Contract Audit Agency	Yes	Study under way
Defense Finance and Accounting Service	Yes	See Mr. Keevey's discussion
Defense Investigative Service	Yes	
Defense Information Systems Agency	Yes	No progress to date
Defense Logistics Agency	Yes	Rear Admiral (Sel) McCarthy's discussion
Defense Mapping Agency	Yes	Study under way
Defense Nuclear Agency	No	
Department of Defense Education Activity	Yes	Useful metrics are readily available
On-Site Inspection Agency	No	

Table 1
Feasibility of Performance Budgeting

Panel 3

Accountability and Results in Business Process Reengineering

Ms. CYNTHIA KENDALL

Deputy Assistant Secretary of Defense (Information Management),
Office of the Assistant Secretary of Defense for Command, Control,
Communications, and Intelligence (OASD [C3I])



Ms. Kendall opened the panel discussion by providing an overview of business process reengineering (BPR) and its implementation within DoD.

BPR enables DoD to implement the administration's goals for capitalizing on emerging information technologies. A key premise of BPR has always been that process redesign and cultural issues should be addressed first, and that technology should be applied to support redesigned processes, rather than technology being the driving force. Ms. Kendall also pointed out that BPR supports many existing and pending government-wide initiatives, not the least of which is the simple need for good management.

BPR is often discussed in the same context as quality management. As indicated in Figure 1, the DoD view is that these are part of a continuum, with quality management focused on refining performance within an existing organization, while BPR addresses radical redesign of organizations and processes.

Within DoD the primary responsibility for reengineering rests with OSD principal staff assistants, the services, and the CINCs, for they are the owners of the department's functional processes. OASD (C3I) is responsible for providing department-wide support, a responsibility that is implemented by estab-

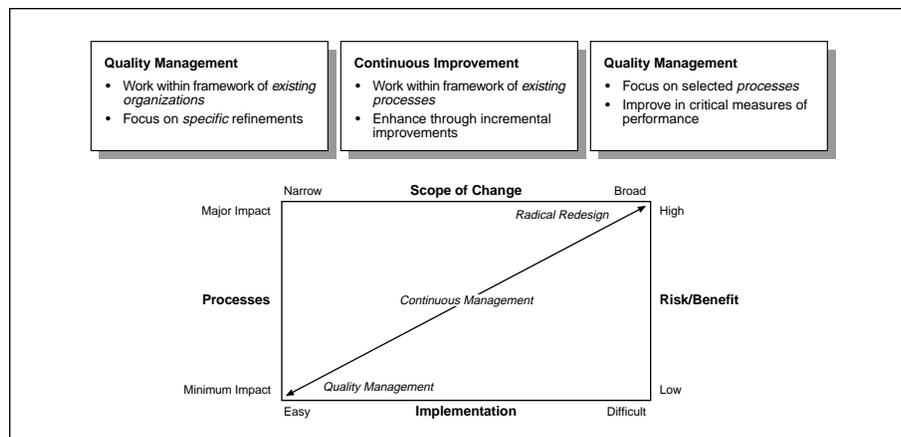


Figure 1
BPR and Quality Management

lishing policy and procedures, furnishing supporting tools and information, and providing training.

Ms. Kendall cited several BPR success stories. Of the 148 BPR projects funded through the Corporate Information Management (CIM) Central Fund, the 38 that have reached the point of business case analysis are projected to save over \$10.5 billion on a total investment of less than \$1.8 billion (\$20 million to conduct reengineering and \$1.7 billion in initiatives). She noted that after project approval, implementation remains a management challenge.

The key issue in performance measurement is getting the right information to the right decision-maker on time. This requires identifying information requirements, determining the required timing to support decision-making, keeping the cost of information in line with the anticipated benefits, and making informa-

tion understandable for its intended purpose. It is also important to ensure that bad news is not hidden from managers. Ms. Kendall noted the observation of Tom Peters that “what gets measured gets done,” meaning that most workers will strive to achieve established performance targets and that managers must therefore view performance measures as a means of influencing behavior.¹ Thus, performance measures must be selected with care.

Ms. Kendall concluded with a discussion of lessons learned in managing the BPR program. Chief among these lessons are the essentiality of top management commitment and buy-in, the challenges associated with technical and functional stovepipes, the need to close the gap between BPR project approval and Planning, Programming, and Budgeting System (PPBS) investment approval, and the importance of establishing solid performance indicators.

DR. DAVID CHU

Director, Washington Research Department, RAND



Dr. Chu's thesis was that the primary goal of reengineering should be to drive down the cost of DoD's supporting infrastructure. The primary obstacle is that BPR projects tend to be too narrowly focused. This problem can be found in two types of situations. The first type comprises projects that focus on isolated functional activities rather than on cross-functional processes. The second type consists of pro-

jects that focus on information technology (IT) rather than on the broader functional activities that the technology is intended to support. What is needed is a systems approach, which would give managers a context for pushing the boundaries of their reengineering efforts.

Dr. Chu warned that as reengineering proceeds, managers should be alert to the unin-

¹In common usage and in this paper, the terms “performance measure” and “performance indicator” are used interchangeably. The latter term is formalized in the Government Performance Results Act of 1993, while the former term is more commonly used in business and government literature. The terms refer to the metrics or units of measure that are used to assess performance and to gauge progress toward established goals.

tended consequences of their reforms. Reforms create new incentives, and it is frequently difficult to predict how individual actors and agencies will respond to those incentives as sometimes producing consequences very different from the ones intended.

In the area of performance measurement, Dr. Chu has found that indicators too often address inputs rather than outputs and outcomes. Input management is important for supervisors, but outputs (and eventually outcomes) are what tell us how well DoD's infrastructure functions are supporting the forces. Customer satisfaction is an important aspect of performance measurement, one that is not easy to address. Dr. Chu observed that the department has not made best use of available techniques in this area.

Related to his discussion of managing inputs vs. outputs and outcomes, Dr. Chu mentioned the acquisition review process, specifically the reviews conducted by the Major

Automated Information System Review Council (MAISRC) and the Defense Acquisition Board. He noted that these reviews focus on information systems and weapons systems, but rarely and ineffectively on the supported functional activities. Unfortunately, it is easier for senior managers to deal with capital investment decisions for systems than to deal with understanding the impact on supported activities.

Dr. Chu concluded by suggesting that it can be worthwhile for managers to consider how little, rather than how much, needs to be done to achieve the desired functional goals. This is a potentially powerful way to improve the performance of a function. Managers should ask how austere a supporting activity can be and still provide the required support.

Performance indicators should be developed to support this orientation. Such an approach tends to result in simplification and decentralization of functions, along with improved support.

DR. DIANE DISNEY

Deputy ASD (Civilian Personnel Policy),
OUSD for Personnel and Readiness (P&R)

Dr. Disney was the first of two speakers asked by Ms. Kendall to discuss reengineering experiences in specific functional areas. She addressed the reengineering of DoD civilian personnel management.



civilian work force for DoD. Drivers for the reengineering include a number of national and DoD initiatives, all aimed at improving the effectiveness and efficiency of infrastructure functions.

Dr. Disney stated that the reengineering of civilian personnel management has, as suggested by Dr. Chu, tried to take a systems approach by redesigning the way the entire civilian personnel management function is performed. The desired outcome is to attract, develop, and maintain the best and brightest

The reengineering effort has three themes:

Civilian personnel management services must be structured to better meet customer needs. This requires dramatic improvement of systems and procedures.

The number of human resource professionals must be significantly reduced, with reductions based on improvements in processes and structure.

Investments are imperative and will result in immediate and continuous benefits.

The overall approach to the reengineering effort was to create a two-part structure employing regional service centers and local support units. The approach also includes the development and deployment of a modernized information system. A number of system shortfalls have had to be overcome to achieve this, including cumbersome, time-consuming systems, duplicative databases, a complex architecture, and non-user-friendly systems. Thirteen separate process improvement initiatives are now under way to deal with the shortcomings.

Dr. Disney said that the long-term goals for personnel management are modernization of the Defense Civilian Personnel Data System, regionalization of service delivery, and systems modernization. These are expected to generate the benefits, or outcomes, highlighted in Figure 2.

Dr. Disney concluded by noting the following challenges for the future in civilian personnel management:

- ◆ Integrating software and information technology professionals.
- ◆ Training human resource professionals.
- ◆ Generating positive awareness.
- ◆ Managing the change.

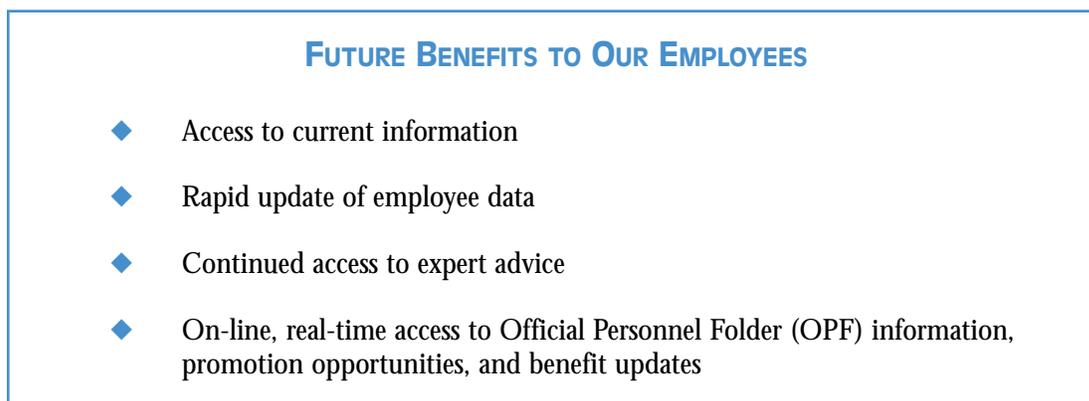


Figure 2
Civilian Personnel Reengineering Benefits

MR. JOHN PHILLIPS

Deputy USD (Logistics)



Mr. Phillips was the second speaker to discuss reengineering experiences in a specific functional area. He addressed the reengineering of the DoD logistics process.

Logistics reengineering is being driven by the cost imperative. Mr. Phillips noted that during DoD's major downsizing, operations and maintenance (O&M) costs have not decreased as rapidly as have the investment and military personnel accounts, and that these O&M costs are largely associated with logistics functions. The logistics tail that supports operating forces is sizable and presents considerable opportunities for reengineering and cost reduction. However, it must also be recognized that the logistics process is an integrated, complex system that involves many subordinate processes, such as transportation, supply, and maintenance, and interfaces with external processes such as contracting and finance.

Mr. Phillips noted that technology plays a key role in logistics reengineering. He cited examples of technology applications that have brought dramatic improvements in such performance factors as fuel consumption and mean time between maintenance for aircraft engines, mean time between failure for inertial navigation systems, and replacement rates for truck tires. In addition to having operational benefits, each of these applications has generated significant cost savings. Technology insertion is viewed as having tremendous potential for further financial benefits; ODUSD (L) envisions an annual investment in technology insertion that will eventually

ramp up to \$500 million, and anticipates a 45 percent return on this investment.

Mr. Phillips described a number of specific initiatives that are part of

logistics reengineering, including total asset visibility, interactive electronic technical manuals, and continuous acquisition life-cycle support. Each of these is projected to combine operational benefits with significant cost reductions.

All the initiatives undertaken as part of logistics reengineering are in support of the Logistics Strategic Plan, which establishes two high-level goals:

- ◆ Reduce logistics cycle times.
- ◆ Develop a seamless logistics system.

Reduction of cycle times is critical because it will provide operational forces with more responsive support and lead to significant cost reduction. As an example, Mr. Phillips noted that maintaining the supply pipeline for secondary items of supply costs \$52 million for each day items are in the pipeline. Reducing this cycle time will clearly generate meaningful savings.

The seamless logistics system is needed in order to overcome the difficulties associated with operating and maintaining the more than 500 automated information systems (AISs) currently used in logistics.

PERFORMANCE INDICATOR	TODAY	FY2001 TARGET	COST BENEFIT
Customer order pipeline time	49 days	3-10 days	\$2.5 billion
Administrative lead time	177 days	90 days	\$6.0 billion
Wholesale logistics AISs	367+	24	
Maintenance depots	24	5 equivalent fewer	\$1.5 billion/year
Distribution depots	30	8 equivalent fewer	\$200 million/year
Inventory control points	17	3 equivalent fewer	\$600 million/year
Wholesale parts inventory	\$77.5 billion	\$56 billion	Cost avoidance

Table 2
Logistics Performance Targets

Mr. Phillips emphasized the importance of establishing quantifiable performance targets to drive performance improvements. He presented the performance targets in Table 2 from the DoD Logistics Strategic Plan.

He summarized by noting that DoD's operating forces in the future will be tremendously capable, and that the department is working now to build the 21st century logistics system that will support these forces.

DR. BARBARA FALKNER

Director, Strategic Strike and Arms Control Division,
Program Analysis and Evaluation Directorate, OSD



Dr. Falkner described the role of her office, noting that she is the PA&E focal point for CIM, BPR, MAISRC, and most other matters related to the CIM initiative and automated information systems.

Dr. Falkner said that there are two general approaches to dealing with the relationship between BPR and IT modernization. One is to focus on BPR first and systems modernization later; the other is to reverse the order. She noted that CIM advocates putting BPR first. Some current actions, as represented by the Global Command and Control System/Global Combat Support System philosophy, put the system in the lead. She also noted that an analysis of the FYDP shows that operating and support costs for IT are generally flat in the outyears, leaving little opportunity for savings. This leads to the conclusion that infrastructure savings must come from process reengineering rather than from systems; the “BPR first” approach seems better suited to finding ways to achieve these savings.

Dr. Falkner described the three phases of process improvement as program initiation, program implementation, and program assessment and monitoring. Analytical techniques and oversight mechanisms generally exist to support the first two phases, but not the third. This shortcoming means that it is difficult to define and track costs and benefits within a functional area and to establish accountability for measurable project results.

The primary analytical technique that supports the program initiation phase is the functional economic analysis (FEA), while the implementation phase is supported by the MAISRC and the program review. There are concerns with each of these.

FEA concerns. FEAs tend to contain broad-brush estimates that are based on limited data. In addition, the benefits projected in FEAs are usually overstated and have limited validation.

MAISRC economic analysis concerns. MAISRC analyses generally do not present realistic alternatives to the preferred program, usually focus on an AIS rather than on a complete functional process, and do not result in decisions based on economic factors such as benefits or return on investment (ROI).

Program review concerns. Dr. Falkner observed that during the program review it has been difficult to argue successfully for funding adjustments, difficult to reach agreement on expected benefits and ROI, and difficult to find acceptable offsets to proposed program increases. She presented examples of several cases that indicate that success during program review (where success is defined as approval for increased funding) does not appear to be based on the existence of a complete FEA or on high projected ROI. Table 3 summarizes these examples.

PROGRAM	FEA	ROI	OUTCOME
Materiel Maintenance Standard System (MMSS)	Yes	8:1	Some funds added; not as much as requested
Depot Maintenance Standard System	Yes	4:1	Funding reduced and transferred to MMSS
Standard Procurement System (SPS)	Yes	8.7:1	FY97 request granted; out-years deferred
Total Asset Visibility	No	-	Full request granted
Transportation Systems	?	-	Full request granted
Installation Management	No	-	No funding added

Table 3
Programs Requesting Added Funds in FY97-01 Program Review

DISCUSSION AND QUESTIONS

Several questions and comments followed the formal presentations.

Dr. McNicol asked about the expected impact on the BPR program of the Program Decision Memorandum decision to reduce the CIM Central Fund. (This decision directed that the CIM Central Fund, a primary source for funding BPR projects, be reduced by 50 percent and that any manager who wished to use the fund would be required to provide dollar-for-dollar matching funds.) Ms. Kendall said that an initial analysis of ongoing BPR projects indicates that most functional managers are committed to continuing their reengineering efforts and that they intend to provide the matching funds.

Dr. Jules Bellaschi, Deputy Director of Army PA&E, noted that it is important in the area of benefits to ensure that cost avoidance not be confused with savings. A cost avoidance is an unplanned cost that will not have to be

incurred, while savings are planned costs that will no longer be required. The danger is that if a cost avoidance is misidentified as savings, it could result in funds being removed from a program in cases where there was no money in the first place.

Dr. Myron Myers, Program Director, Logistics Management Institute, posed the question of what happens to savings from BPR projects. He said that allowing the savings to accrue to the manager who developed the project can serve as a positive incentive for reengineering; if, on the other hand, savings are lost to the manager, there is no incentive. Dr. Chu responded that this is a real problem, symptomatic of the difficulties involved in establishing incentives for public-sector organizations. Dr. Chu noted that at the service level, leaders seem to understand and accept the need for trade-offs across functional areas, but that this is harder to do at the OSD level. Ms. Kendall observed that it is difficult to demonstrate that BPR projects are driving infrastructure costs

down, especially since in many cases reengineering is being applied after the fact to functional processes from which anticipated savings have already been harvested. This occurred frequently as a result of Defense Management Review Decisions in recent years.

Mr. Mike Dominguez, Associate Director for Programming, Programming Division, Deputy Chief of Naval Operations (Resources, Warfare Requirements and Assessment), raised the concern that centralized AIS programs tend to be counterproductive. He said that when programs are directed and funded from the OSD level rather than by each military service, the services become disenfranchised from the benefits and from a sense of commit-

ment to making the investments effective. He suggested that programs need not be centralized in order to be effective. To support this view, he noted that for many joint, non-AIS programs the issues are discussed, decisions made, and each service is expected to make its internal trade-off decisions in order to provide funding for its portion of the program. This decentralized approach allows discussion and debate at the DoD level to focus on the function being supported rather than on the investment decision. In the “centric” approach to AISs, the debate tends to focus on the centralized investment decision rather than on the functional requirements and benefits. The resulting decisions do not lend themselves to monitoring and accountability. ❖

Panel 4

DoD Privatization and Outsourcing: Toward More Implementation

MODERATOR: DR. JOHN CHRISTIE

Senior Research Fellow, Logistics Management Institute

Dr. Christie opened the panel discussion with brief introductory remarks. He reviewed the Deputy Secretary's initiative to implement privatization and outsourcing in the Department of Defense as a means toward achieving greater efficiencies and reducing costs. He mentioned



that the panelists would provide a variety of perspectives on the issues associated with implementation: OMB Circular A-76 implications, contractual issues, and operational factors from the military commander's point of view. He then turned over the discussion to Mr. Goodman.

MR. JOHN GOODMAN

Deputy Assistant Secretary of Defense (Industrial Affairs)

Mr. Goodman reviewed the capabilities of the private sector, noting that in many areas the private sector can now provide services faster, cheaper and better than the federal government and it can assist in making DoD more efficient. To take advantage of these abilities, DoD must change its culture and change the laws and regulations that make outsourcing difficult.

Mr. Goodman stated that we have to change a culture that believes readiness will be compromised without total control of resources. In some cases there may be an empire problem—that is, believing one's own importance in the bureaucracy is determined by how many people one controls. Further, some believe that the military is unique, that it is too large and too different from the private sector. We have to find those areas where the private sector can



meet our service needs, such as Brown and Root in Bosnia and Federal Express in distribution.

We also have to change the law. Prime candidates for change are the 60/40 split in depot maintenance and those spelling out decision-making procedures. Because of excess laws and regulations, outsourcing can be difficult and people can use the difficulty as an excuse not to try.

Mr. Goodman noted that the military services need to determine what makes sense. We have to make the case that outsourcing can benefit the warfighters by drawing on the experience of the private sector. To do so, DoD established a Defense Science Board task force. The department plans to make the case forcefully to the next session of Congress.

REAR ADMIRAL (RET) DAVE OLIVER

Director of Analysis, Electronic Systems Group,
Westinghouse Electric Corporation



Admiral Oliver asserted there are two problems, usually unspoken, that successful efforts at privatization must understand and address in some fashion:

Control. Military commanding officers want to know that they can quickly affect the processes. Currently they achieve this through their lifetime of personal relationships with the individuals working for them, as well as through the military system of grading and assigning personnel. Commanders need assurances and mechanisms to ensure that the private or commercial process will be responsive to their control.

Uncertainty. Just like many civilian companies, military personnel are being evaluated on what they can do in the short term, and given the way the personnel assignment system works, this evaluation often considers only the first three to six months of a particular assignment. The commander's short-term performance affects which job he or she will be offered at the end of a two- or three-year tour. As a result, commanders want the ability to quickly set a new direction.

Admiral Oliver suggested that money is often not an important issue for the commander who has the option of privatizing all or part of his assets, for he does not have the visibility into the total costs of his processes (especially manpower) and thus is not "empowered" to make trade-offs.

While the local commander may not be able to articulate this problem, he subconsciously recognizes the shadow it casts and its effects,

and thus is not as interested as one might expect in forecasted savings that are going to make someone else (who does not have the responsibility for local performance) look good. As a result of this real prob-

lem, to engender real enthusiasm, either accounting systems and processes must be changed, or the commander must be sold on the increased military effectiveness of commercialization and privatization. (The latter is probably more feasible in the short run; however, both actions are necessary.)

Admiral Oliver felt that focusing on the 20 percent to 40 percent savings that can be expected through privatization ignores several important issues:

Privatization and commercialization encourage change as well as the more rapid adaptation to new technological circumstances. Quicker adaptation to technological change and the power of a capitalistic economy is what won the Cold War, not the size of our Army (smaller than the Soviets') nor the number of our nuclear warheads (also substantially smaller). Adaptation to change in the military coupled with the empowering economic strength of capitalism are the factors that will determine whether the United States survives our next big challenge a decade or so from now.

Unfortunately, at the moment, *the Army, Air Force, and Navy and Marine Corps are the largest remaining socialist organizations in the world.* Privatization and commercialization are the best means to keep those organizations world class.

Our country also needs ways to better couple our military organizations with our country's populace. We do not currently face a threat so challenging that it serves to reinforce our country's support for as well as interest in our military. If, as current predictions estimate, a unifying threat does not arise for a decade or more, will we have lost a generation of young adults who appreciate, understand and remain interested in the policies and strength of our military? Privatization and commercialization offer the opportunity to not only acquaint, but also force periodic contact and align the

interests of more "nongovernmental" individuals with an organization—the military—which during times of peace is often both unattractive and unsupported by a large group of Americans.

In his closing comments, Admiral Oliver noted the importance of forums like this in developing consensus of the importance of privatization and stated that he believed that the best way of keeping a world-class military was to adopt the stretch goal of privatizing everything but combat.

MR. SAM KLEINMAN

Program Director, Center for Naval Analyses



Mr. Kleinman asserted that the goal of outsourcing is to do the right amount. Regarding the perception that DoD is not doing enough, he identified several contributing factors: the inertia of government bureaucracies; the fact that the true costs of the department's doing things in-house are often due to various reasons; the upfront costs to set up and run a competition and the siphoning of savings by headquarters; and the fact that users often have no choice in selecting what should be done or by whom. Mr. Kleinman suggested that more accurate information, incentives, and choices for customers would lead to more outsourcing.

Mr. Kleinman reviewed several studies, including those done by CNA, the Logistics Management Institute, the Office of Management and Budget, and a British firm, that have concluded that 30 percent savings are common and seem to be the median.

These findings all come from public/private competitions, where the public team frequently wins. In the Department of Defense, Mr. Kleinman indicated that about half the competitions are won in-house and there are still savings.

Mr. Kleinman outlined several measures for increasing the number of cost comparisons under the current OMB Circular A-76.

- ◆ He proposed incentives for local commanders of activities. He called on DoD to reinvest savings in local authorities, and to allow local bases and facilities to retain a percentage of the annual savings for a two-year period.
- ◆ He stated that the vast majority of ashore jobs in the Navy are exempt from comparisons with the private sector. He advocated that no part of the support

infrastructure doing commercial work should be exempt from public/private cost comparisons just because it is classified as mission-critical core.

- ◆ He asserted that DoD should have no constraints on the number of people it will employ; there should be no floors or ceilings.
- ◆ Mr. Kleinman called on the services to declare, in appropriate cases, the termination of in-house functions and to decree that they will rely on the private sector. He cited base and facility support at technical and research centers and the maintenance and running of commissaries as examples.
- ◆ He said the services should form “tiger teams” to do performance work statements, citing the length of time the services currently take in developing them. He also called for developing Most Efficient Organizations after requests for proposals are sent to the private sector to remove the advantage that doing MEOs ahead of time can give the public sector.
- ◆ He called for a central clearing house in each service to review proposed contracts. He stated that at each facility, the in-house bidder should be a totally separate group from the customer who will make the final decision. He supported the continuation of an early retirement program and separation incentive program

for all employees affected by public/private competition to show commitment to protecting or at least softening the blow to workers.

Mr. Kleinman outlined his thoughts on how OMB Circular A-76 can be revised to further expand competitions.

- ◆ He called on OMB to allow movement of money for pay and allowances of military personnel to the operations and maintenance appropriations, and some movement of money in these appropriations to military construction appropriations.
- ◆ He asserted that the in-house team should not be given a 10 percent advantage in the cost comparisons.
- ◆ He advocated requiring the military services to conform to the Federal Acquisition Regulation and cost accounting standards.
- ◆ Mischarges, he said, should be prosecuted for both public and private contractors.

Mr. Kleinman outlined a strategy in which, if the public team wins, it signs an agreement, similar to a contract, that guarantees performance at a certain price. The agreement should allow for a recompetition after three to five years, making it parallel to a competition won by a private contractor.

DR. MYRON MYERS

Program Director, Logistics Management Institute



Dr. Myers commented on the key issues and problems associated with contracting for commercial-like services from the private sector. In his view, the benefits of outsourcing depend largely on smart contracting—writing a good contract, selecting the right contractor (not necessarily the cheapest), and effectively managing and administering the effort after the award. If any of these ingredients are not done well, the benefits of outsourcing are likely to be degraded.

Dr. Myers indicated that there are few universal right answers on these contracting matters—just lots of tradeoffs and difficult business judgments to be made. This is especially true when the candidate business functions range from housekeeping services to depot repair of sophisticated equipment and to the provision of information services. Furthermore, we are in an era of great experimentation—in state and local government, the commercial sector, and also DoD’s acquisition reform efforts—and the jury is still out on what works best.

He indicated that a basic tenet of government (public-sector) contracting not present in commercial sector contracting ends up constraining much of what is possible: public sector contracts must be open to all bidders. A corollary to this is that unsuccessful bidders must have the right to protest an award if they feel that the process was compromised or if due process was denied. The public sector’s ability to fully exploit successful commercial methods is sometimes constrained by these requirements associated with an open system.

Dr. Myers developed a taxonomy of five key contracting elements. The key elements are:

1. Defining and specifying the work to be accomplished
2. Identifying the best acquisition strategy to pursue—especially the frequency and intensity of competition
3. Laying out some key contract terms and conditions related to how disputes are to be resolved and whether incentives are to be used
4. Determining how sources are selected
5. Administering the contract after award when in-house capabilities may well disappear.

DEFINING THE WORK

There is now a clear DoD policy preference for performance-based statements of work as opposed to “how-to” specifications. Performance-based statements of work specify desired results, or outcomes, not inputs to be used or steps to be taken. For example, “perform necessary maintenance and repair to the heating and cooling system to keep the building between 70° and 75°” is a results-oriented performance specification. It is up to the contractor to do what is necessary to make it happen and face penalties if it does not. Yet most DoD work statements specify in minute detail precisely what maintenance steps must be

taken on each piece of equipment and when. Not only is this at variance with the notion of performance-based work statements, but the amount of policing to ensure compliance is burdensome and costly.

Finally, the added advantage of performance-based work statements (and the reason they have attracted much attention) is that they encourage the offer of commercially available goods and services that meet the need but that do not necessarily conform to detailed specifications.

ACQUISITION STRATEGY

Dr. Myers indicated that one of the fundamental issues is what he calls continuous competition versus long-term partnering. With the former, several contractors are under contract and work is assigned to one or the other as work materializes based on competition or performance. There is actually a new statutory preference for this type of arrangement in the new Federal Acquisition Streamlining Act (FASA). In contrast, long-term partnering with cooperation and mutually aligned interest is a long-standing but by no means universal commercial practice. It seems to be popular when a heavy facilities investment is required and when the work is complex.

Some constraints limit DoD's use of long-term partnering arrangements. There is a maximum five-year contract term rule for services contracting designed to prevent a barrier to market entry—again, based on the desire to keep the system open and available to all. Secondly, commercial arrangements typically provide for shared savings from productivity gains, but in DoD, its share of permanent savings often must revert to the Treasury rather than the contracting agency (off-budget financing is the issue). Finally, FASA prefers multiaward/continuous competition.

KEY TERMS AND CONDITIONS

Dr. Myers discussed disputes. He reiterated that the open system creates a major division between commercial and public contracting. In commercial contracting, disputes are generally resolved by negotiation; litigation is a last resort, and it usually implies the end of a relationship.

In contrast, in public contracting, litigation—at least in theory—does not affect possible further relationships. Absent suspension or debarment, the litigious contractor is free to offer again and must be treated impartially in the next source selection process.

DETERMINING SELECTION OF SOURCES

Dr. Myers asserted that we face a major cultural barrier—namely, resistance from DoD contracting personnel, which is unfortunate but nevertheless understandable. Meanwhile statutes, procurement policy, and the courts are all working in the right direction. DoD policy is moving to “best-value” contracting, which permits paying more if doing so is justified by a better product or service. This means that various technical characteristics of the offered service that exceed the minimum essential requirements can be recognized and valued.

Prior DoD experience with the contractor can now also be used for source selection purposes. Recognizing prior experience is the standard commercial practice and is the way people behave every day as individuals.

The courts are upholding DoD's decisions to award contracts to other than the low bidder if there is a rational basis for the decision.

The use of past performance as a selection criterion, although rational, is not simple

because of the requirement for an “open system.” The losing offerer can claim that the evaluation of his past performance was subjective and even biased and that he is being denied due process. Thus safeguards are required to allow an offerer to review and appeal unfavorable evaluations of his past performance.

Despite the reform effort directed toward best-value contracting, it has been our observation that *lowest acceptable price* still largely prevails in DoD contractor selection. Contracting officers are understandably more comfortable being able to point to the objective factor of best *price* rather than the somewhat subjective best value when oversight organizations—the Government Accounting Office (GAO), Inspectors General, etc.—come in to examine decisions.

CONTRACT MANAGEMENT

Dr. Myers asserted that, in many ways, contract management is as critical as the considerations that go into defining the work, the acquisition strategy, and source selection methodology. It seems to be the factor that industry in particular has inadequately dealt with. DoD, on the other hand, has long had an apparatus in place to deal with day-to-day contract administration.

Work statements invariably require extensive revision, especially when they are the initial outsourcing work statement, when the contract term is lengthy so new requirements occur, or when substantial technical change is occurring. When the work is performance-based, there is a special need to monitor contract performance. Thus, there is a difficult tradeoff between devoting overhead resources to perform vital contract administration functions on the one hand, and achieving near-

term cost savings on the other. Retaining some in-house capability to monitor and administer the contract and to be in a position to re-compete the follow-on work has much to recommend it. However, all too often, near-term savings wins.

Dr. Myers then summarized.

While best-value contracting, in which technical and performance considerations and past performance are source selection factors, is still the exception in DoD, it should be the rule. The lowest technically acceptable price provides a comfort factor, but GAO and the courts are blessing well-constructed best-value procedures more and more.

Results-oriented, performance-based work statements are gaining use in private-sector and DoD outsourcing, but DoD needs more experience in their use.

The trend toward long-term partnering-type relationships continues in the private sector. But in the public sector, a requirement to give everyone a chance limits the term of DoD service contract term to five years. Shared savings from productivity gains revert to the Treasury, lessening their benefits and incentives for buying activities. FASA actually states a preference for continuous competition.

Finally, ineffective contract administration can degrade outsourcing benefits. The loss of in-house technical capability resulting from outsourcing can create problems for effective administration of the ongoing work, the capability to write the next contract and for handling surges in workload. The private sector is especially prone to cut in-house capability to gain a quick competitive edge.

GENERAL DISCUSSION

A number of key points were raised during the ensuing general discussion with the representatives of the “Mil 5” (the programmers from each of the four military services and the joint staff). The Deputy Director (Resource Analysis) in OSD PA&E is a frequent attendee at the Mil 5 meetings held with the Director, PA&E.

MajGen John Handy (Director of Programs and Evaluation, Office of the Chief of Staff, Air Force) stated that the focus should be on “divesting,” as opposed to only privatization. He indicated that incentives are key, although they do not have to be large. He called for avoiding “cookie cutter” solutions and suggested that no one takes issue with the concept of divesting where it makes sense to do so. He stated that a great deal of further study was not necessary, and advocated pressing ahead aggressively. He mentioned that it is essential to work with congressional staffs to obtain legislative relief, and closed by saying that the Air Force is working A-76 issues very hard and finding ways to move ahead within that framework.

Mike Dominguez (Associate Director for Programming, Programming Division [N80], Deputy Chief of Naval Operations [Resources, Warfare Requirement and Assessment]), in contrast to MajGen Handy’s remarks, indicated that the Navy was taking a more cautious approach. He underscored the importance of top-level support for privatization as a key to its implementation, and stated that changes need to be initiated within the services, including cultural adjustments. He described the terms “contracting” and “partnerships” as being very dissimilar. Mr. Bill Tuttle, President of the Logistics Management

Institute, observed that the Mobile Subscriber Equipment program and operations at Cape Canaveral in Florida are two examples where long-term contracting partnerships have been established and which are working well.

Dr. Jules Bellaschi (Deputy Director of Program Analysis and Evaluation, Office of the Chief of Staff, Army) indicated that privatization will certainly be taking place. He underscored the differences in privatization contracting with standard contracting vehicles, and emphasized that the services must retain the capability to understand, process, and manage these different kinds of contracts.

Dr. McNicol indicated that the focus seems to be on base operations support and logistics functions so far. The Department of Defense Dependent Education, commissaries, and other apparently good privatization candidates have been treated as “porcupines” to date. Mr. Goodman indicated that in fact seven functional working groups are in the Privatization Integrated Process Team. Of these, he noted, materiel management and base commercial activities were the “flagships” of privatization efforts to date.

Admiral Oliver commented that Dr. McNicol’s remarks—that during the last budget cycle the services had all opposed privatizing the commissaries and medical establishments, organizations for which there are quality commercial substitutes—demonstrate how hard we have to reach to get enough people to recognize the value-added features privatization inherently provides.

He stated that at this time in our history, he believes privatization is much more important than any particular weapon purchase or troop deployment decision and must be aggressively

pursued accordingly. He said privatization was an important issue for this administration and that the window of opportunity is often as fragile as a Christmas sugar fairy, for momentum may well be lost if there is a change in administration.

Mr. Goodman asserted that the initiative must continue, regardless of any potential changes in the administration. He remarked on the need for early successes to establish momentum.

Mr. Kleinman suggested that more can be privatized in the area of housing. Many studies

have concluded that it costs more when the program is administered by DoD. He also suggested that a way to privatize education and training is to adopt a strategy in which the services bring already-trained people onboard.

Mr. Tuttle called for the services to concentrate their efforts on the warfighting areas. He suggested that commanders should not have to be worried about costs and industrial matters. A cultural breakthrough is needed, in his view.

CONCLUSION

This symposium, the first of its kind to focus on infrastructure resources, resulted in substantive discussion of many significant issues. It has become clear that forums such as this are critical to exchanging ideas and advancing our thinking about the implications of major initiatives to reduce infrastructure costs while maintaining effectiveness.

While much was accomplished as a result of this first symposium, more work needs to be done. Accordingly, the Logistics Management Institute will cohost, with the Deputy Director (Resource Analysis), Program Analysis and Evaluation, another symposium later this year or early in 1997. Several modifications to the format are under consideration, including the addition of one or more short tutorials.

“All great changes are irksome to the human mind, especially those which are attended with great dangers and uncertain effects.”

John Adams

Symposium Participants

Appendix A

OFFICE OF THE SECRETARY OF DEFENSE

Irv Blickstein, Director, Program Integration, Office of the Under Secretary of Defense (Acquisition and Technology)

Dr. Richard Burke, Chief, Operation Analysis and Procurement Planning Division, Program Analysis and Evaluation Directorate

Dr. Craig College, Chief, Force Structure and Infrastructure Cost Analysis Division, Program Analysis and Evaluation Directorate

Bill Coonce, Director, Revolving Fund, Office of the Under Secretary of Defense (Comptroller)

Dr. Diane Disney, Deputy Assistant Secretary of Defense (Civilian Personnel Policy)

Dr. Barbara Falkner, Director, Strategic Strike and Arms Control

Lou Finch, Deputy Under Secretary of Defense (Readiness)

John Goodman, Deputy Assistant Secretary of Defense (Industrial Affairs)

Dr. Michael Ioffredo, Deputy Director (Strategic and Space Programs), Program Analysis and Evaluation Directorate

Cynthia Kendall, Deputy Assistant Secretary of Defense (Information Management)

Kristy Kolesar, Senior Operations Research Analyst, Economic Analysis and Resource Planning Division, Program Analysis and Evaluation Directorate

Dr. David McNicol, Deputy Director (Resource Analysis), Program Analysis and Evaluation Directorate

David Norem, Office of the Deputy Assistant Secretary of Defense (Information Management)

Jerry Pannullo, Senior Operations Research Analyst, Economic Analysis and Resource Planning Division, Program Analysis and Evaluation Directorate

John Phillips, Deputy Under Secretary of Defense (Logistics)

Dr. Nancy Spruill, Deputy Director, Acquisition Resources, Office of the Under Secretary of Defense (Acquisition and Technology)

Roy Willis, Principal Deputy Under Secretary of Defense (Logistics)

ARMY

Dr. Jules Bellaschi, Deputy Director, Program Analysis and Evaluation, Office of the Chief of Staff, Army

Paul Roberts, Director, Investment Division, Army Budget Office

NAVY

Gladys Commons, Principal Deputy Assistant Secretary of the Navy (Financial Management)

Michael Dominguez, Associate Director for Programming, Programming Division (N80),
Deputy Chief of Naval Operations (Resources, Warfare Requirements and Assessment)

Lisa Smith, Naval Facilities Engineering Command

MARINE CORPS

MajGen Jeffrey Oster, Deputy Chief of Staff for Programs and Resources

Col Robert Hansen, Programs and Financial Management, Office of the Deputy Chief of Staff
Installations and Logistics

LtCol Steve Quintmeyer, Head, O&M Budget Branch, Office of the Deputy Chief of Staff
Installations and Logistics

AIR FORCE

John Beach, Principal Deputy Assistant Secretary of the Air Force (Financial Management and
Comptroller)

MajGen John Handy, Director, Programs and Evaluation

DEFENSE AGENCIES

George Hoffman, Comptroller, Defense Information Systems Agency

Richard Keevey, Director, Defense Finance and Accounting Service

Gary Lutz, Deputy Director, Resource Management, Defense Commissary Agency

RADM (Sel) Justin D. McCarthy, Comptroller, Defense Logistics Agency

GUESTS FROM ORGANIZATIONS OUTSIDE DoD

Dr. David Chu, Director, Washington Research Department, RAND

Debbie Clay-Mendez, Analyst, Manpower and Support Analysis, Congressional Budget Office

Dr. Carl Dahlman, Washington Research Department, RAND

Julia Denman, General Accounting Office

Sam Kleinman, Program Director, Center for Naval Analyses

RADM (Ret) David Oliver, Director of Analysis, Electronic Systems Group, Westinghouse Electric Corporation

Dr. Bill Rogerson, Economics Department, Northwestern University

Neil Singer, Deputy Assistant Director, Manpower and Support Analysis, Congressional Budget Office

Roger Sperry, National Academy of Public Administration

Carla Tighe, Vice President, Center for Naval Analyses

Kathleen Utgoff, Vice President, Center for Naval Analyses

David Warren, Director, Defense Management and NASA Issues, General Accounting Office

Dr. Cindy Williams, Assistant Director, National Security, Congressional Budget Office

Gene Porter, Center for Naval Analyses

LOGISTICS MANAGEMENT INSTITUTE

William G.T. Tuttle, President

Robert K. Wood, Vice President

Norman E. Betaque, Jr., Vice President

Dr. Myron G. Myers, Program Director

Edward D. Simms, Jr., Program Director

Dr. John D. Christie, Senior Fellow

William Fedorochko, Senior Fellow

Irving Greenberg, Senior Fellow

Milton A. Margolis, Senior Fellow

Donald W. Srull, Senior Fellow

Joan Freeman, Resident Research Fellow

Walter R. Cooper, Research Fellow

William J. Esmann, Research Fellow

Matthew D. Fuller, Research Fellow

Joseph Romito, Research Fellow