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| [Pentagon’s Bloated Supply Chain Targeted for Savings](http://www.nationaldefensemagazine.org/blog/Lists/Posts/Post.aspx?ID=826) |

**By Sandra I. Erwin **

The U.S. military buys, stores and maintains supply stocks that it does not need. It operates too many warehouses that have questionable utility. And it often overpays for goods that can be purchased for less at regular retailers.

In Pentagon lingo, these are the “back end” costs of military operations that have risen unchecked for decades.

[The Willie Sutton principle applies to defense logistics: It’s where the money is.](http://www.nationaldefensemagazine.org/archive/2012/July/Pages/DefenseIndustryTargets%24150BWeaponsMaintenanceMarket.aspx) A report by Deloitte Consulting LLP estimated that yearly military spending on maintenance of equipment, with associated supplies and transportation, is upwards of $150 billion — about $80 billion for weapons upkeep and $70 billion for supplies and spare parts.

The officer who oversees a major portion of the Pentagon’s logistics business says there is no easy way to control these runaway costs.

“That’s a tough one,” says Vice Adm. Mark Harnitchek, director of the Defense Logistics Agency, in Fort Belvoir, Va.

Only six months since taking over DLA, Harnitchek has directed the agency to shave $10 billion in costs over the next five years. Most of DLA’s expenses — about $46 billion last fiscal year — are straight purchases of stuff. Overhead costs are about five billion a year.

“Our theme for the [fiscal year 2014] program budget review is to reduce cost and improve support,” Harnitchek tells reporters June 27 at a breakfast meeting.

Bloated inventories, rather than staff, will be targeted for savings. None of the agency’s 27,000 civilian employees are being laid off, says Harnitchek.

Achieving the $10 billion savings goal “is going to be a challenge,” he says. Reductions in the demand for supplies — which predominantly is driven by military deployments — will not be counted in the savings. A DLA warehouse in Kuwait that is scheduled to be shut down in February, for instance, will save $90 million a year but will not be part of the $10 billion target, says Harnitchek.

Overbuying supplies is not unusual in the U.S. military, but with the Pentagon under pressure to cut spending, the culture of plenty is becoming unaffordable, he says. DLA has almost as large an infrastructure today as it did in 1992 when the agency was assigned responsibility for distributing supplies to all branches of the military. “We were in 26 places in 1992. We’re still in 26 places in 2012,” says Harnitchek. “We have less square footage but we are still in 26 places.”

Unnecessary supply stocks are a huge financial drain, he says. “We need to do a better job buying inventory. We buy way too much inventory that we don’t use, and we keep it too long.”

Food items and pharmaceutical products are examples of inventories that the Defense Department must shed, Harnitchek says. Supplies that are easily obtainable from commercial companies will no longer be stockpiled by DLA, he adds. “We manage a lot of inventory that could be purchased at Lowe’s or Home Depot. … Why spend $11 to manage a bag of nuts that costs 75 cents?”

More savings also could be squeezed from fuel purchases, Harnitchek says. The Defense Department spends about $15 billion a year on fuel, and consumes on average 130 million barrels of oil per year. DLA is studying ways to better time the market so it purchases fuel when prices are lower. Currently fuel buys are made based on demand.

Another means of cutting cost will be to better manage contractors. Lax management contributed to $750 million worth of disputed charges by Supreme Foodservice, a company that supplies food to U.S. troops in Afghanistan. Harnitchek says DLA has recouped $87 million so far, and negotiations with the firm continue. Although he has no knowledge of whether the charges were fraudulent, Harnitchek recognizes that DLA is partly to blame for not properly overseeing additional requirements — such as food airlift services — that were requested from the contractor and for which the company claimed higher costs than had been originally estimated.

When buying commodities such as spare parts, DLA plans to expand the use of reverse auctions, where suppliers bid against one another, says Harnitchek. “It works pretty well in areas where you have a lot of competition,” he says. Estimated savings range from 5 to 20 percent.

Many of the spare parts the military needs, however, are not available commercially or are technologically obsolete. The way to handle that is to make the [manufacturers responsible for supplying those components under “performance based logistics” contracts](http://www.nationaldefensemagazine.org/archive/2012/July/Pages/DefenseIndustryTargets%24150BWeaponsMaintenanceMarket.aspx), says Harnitchek.

Contracting problems aside, military analysts have blamed the Pentagon’s rising logistics costs on practices that are rooted in the Cold War way of doing business. The Defense Department measures the performance of its logistics system in “customer wait-time,” a term that describes how long troops have to wait to receive parts or supplies they requested. As a result, supplies are ordered multiple times, just in case previous orders get delayed in the transportation pipeline. The Pentagon in the mid-1990s sought a more efficient Wal-Mart style “just in time logistics” supply system, but that didn’t work either because the Pentagon cannot accurately predict consumption and respond to supply requests on short notice.

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# Defense Industry Targets $150B Weapons Maintenance Market

**July 2012**

By Sandra I. Erwin

The defense industry’s new favorite acronym: O&S.

Operations and support, or operations and sustainment, is military-speak for the unglamorous work of maintaining, refurbishing and overhauling Pentagon hardware, some of which is decades old.

Whereas military contractors’ Holy Grail for decades has been the production of new weapon systems, O&S now is garnering the attention of the industry’s top guns.
And for good reason.

The Willie Sutton principle applies to defense logistics: It’s where the money is. A report by Deloitte Consulting LLP estimated that yearly military spending on maintenance of equipment, with associated supplies and transportation, is upwards of $150 billion. “It is a huge percentage of the DoD’s discretionary spending,” the study said. If the trend holds, O&S accounts — about $80 billion for weapons maintenance and $70 billion for supplies and spare parts — eventually will dwarf the Pentagon’s $100 billion annual budget for procurement of new equipment.

The relatively large sums that the Defense Department is projected to spend on O&S do not, however, guarantee easy money for industry. Companies in pursuit of opportunities in this sector can expect cutthroat competition both from other firms and from government depots that have powerful allies in Congress. Contractors in this market also will see growing pressure from military customers to lower prices and, in some instances, to relinquish proprietary weapon-system designs to the government so that more of the workload can be shifted to public depots.

O&S dollars also could become targets of budget cutters, especially as current wars wind down and a peacetime mentality kicks in.

To secure long-term survival, companies will have to position themselves in the right niches, said a senior Defense Department official who spoke off the record at an industry meeting.

“Post war, we will have excess capacity,” he said. “Some of it needs to be protected, some needs to go away.”

Most of the military’s logistics and support work today is performed by the private sector. But manufacturers of major weapon systems would like to see the Defense Department pursue more aggressive outsourcing. Rather than award a company a contract for a narrow task, such as a specific repair or maintenance job, manufacturers contend, the Pentagon should embrace “performance-based logistics” contracts. These long-term agreements can be set up in ways that benefit both government and industry, supporters contend. The military has to determine what outcomes it wants — such as x number of airplanes on the flight line or y number of Humvee trucks ready for use each day — and the contractor has to figure out the most efficient and least costly way to deliver that service.

Performance-based logistics, or PBL, came into vogue in the 1990s, but has fallen out of favor since the mid-2000s, when military officials began to openly criticize PBL contractors for price gouging.

Today, less than 5 percent of the Defense Department’s maintenance work is being performed under PBL deals. The current number of PBL contracts is 87, compared to more than 200 in 2005.

In response to criticism, then-Deputy Assistant Secretary of Defense for Material Readiness Randy T. Fowler hired Deloitte to conduct a comprehensive study of PBL contracts, and determine whether they benefit the government.

Deloitte examined 21 weapon systems. It concluded that PBLs can save the government money and increase the readiness of weapons — measured by the number of “operationally ready” systems in the fleet — if contractors are given the right incentives and the government’s requirements are clearly explained.

PBL arrangements are favored by industry because they provide long-term stability and give companies more flexibility to manage resources, compared to traditional transaction-based contracts, said industry experts.

Al Banghart, defense supply chains lead at Deloitte Consulting LLP, said the Defense Department potentially could save up to 20 percent on O&S costs by using PBL contracts, but he recognized that it is difficult to do apples-to-apples comparisons because government and industry have different ways to measure costs and the Pentagon’s older accounting systems do not always provide reliable data.

Retired Army Col. Greg H. Parlier, who is now a logistics industry consultant, said the Defense Department, and the Army more so than the other services, overspends on logistics because it doesn’t base its contracting decisions on the actual needs of the users. “Synching up requirements with supply could save billions of dollars,” he said. “The system is not driven by readiness requirements.”

In a book titled, “Transforming U.S. Army Supply Chains: Strategies for Management Innovation,” Parlier proposes that the military services adopt “mission based forecasting” software tools so they stop buying things that are not needed.

Unless there are better analysis tools to accurately forecast equipment readiness needs, Parlier said in an interview, the Pentagon will not save any money, regardless of whether the work is performed by industry or government depots. “PBL may not survive if we don’t have mission-based forecasting,” he said. “Contractors’ profits used to be in selling parts. It should be readiness.”

A significant obstacle for companies seeking to expand their O&S business is an increasingly fractious relationship between mid-level defense program managers and contractors, he said.

”There is a trust problem,” said Parlier. “What is needed between government and industry is transparency.”

One problem with PBL contracts is that the incentives built into the agreements might not lead to improved equipment readiness, he said. “Our systems don’t allow us to see those outcomes. … Metrics such as fill rates and supply availability have nothing to do with readiness outcomes,” he added. “Until we focus on readiness rather than traditional supply metrics, we’ll continue to have these problems.”

The Deloitte study, Banghart said, does suggest that the Defense Department needs more contracting experts in its work force who can handle nontraditional, complex arrangements such as PBLs. “There are some real pockets of technical expertise inside the Defense Department, some very skilled logisticians,” he said. “But there are not enough. … To really reap the benefits of PBL you need more skilled workers.”

Deputy Assistant Secretary of Defense for Material Readiness Sue Dryden has been designated the leader of a government-industry team that will study ways to cut O&S costs, including more widespread use of PBLs. “She is on a communications campaign to get the word out,” Banghart said. “It will take many months to turn collective opinion around.”

Dryden’s predecessor Randy Fowler, who is now a Lockheed Martin Corp. executive, said it will be up to the private sector to mount a strong case that PBL-style outsourcing is a good deal for the Defense Department.

“Industry should offer DoD credible PBL approaches that capitalize on partnerships, enable flexibility and enhance transparency,” he said. Pentagon procurement officers and managers in many sectors of the defense business are wary of contractors. “DoD has had concerns about PBL cost benefits, particularly in terms of must-pay bills, contractor fee-on-fee costs, and perceptions that PBL equates to contractor logistics support or outsourcing of sustainment,” Fowler said.

Industry should respond by offering pricing flexibility, by becoming more transparent in cost data provided and by partnering with government depots, he added.

Teaming up with public depots is regarded by industry as an important vehicle to secure work for the long run.

Current law (Section 2466 of Title 10 U.S. Code) says that 50 percent of the funds appropriated to a military service or agency for depot-level maintenance and repairs must be performed by the public sector.

The 50/50 split rule — which started out as 70/30 — has been in place for three decades but recently has drawn high-level industry attention after Congress revised the language in the law to expand the definition of what constitutes depot-level work. Under the broader definition — which industry groups have contested — lucrative upgrades and equipment modifications programs that have been in industry’s bailiwick would have to be shared with public depots.

Government depots also are eligible to compete for PBL contracts.

Fowler said public-private rivalries tend to be overblown, and insisted that the Pentagon is interested in having industrial capacity on both sides.

“The United States has made a conscious, consistent decision to establish and maintain depot maintenance capability in both the public and private sectors,” he said. “The current statutory framework, as codified in Title X, provides reasonable mechanisms for the Department to allocate work and foster public-private partnerships,” he added. “We have not experienced any increase in congressional pressure to use organic depots.”

If leaders and managers continue to believe that PBL is only a contractor-provided solution, “we’ll miss the boat,” said Fowler. “PBL is not contractor logistics support.”

Lockheed Martin has a huge stake in this business. It is currently the Defense Department’s top PBL supplier, with more than 25 ongoing programs, Fowler said. Lockheed Martin Aeronautics recently has been in discussions with the Air Force C-5 cargo aircraft system program manager regarding longer-term PBL agreements.

The Navy’s aviation fleet is among the Pentagon’s largest users of these contracts. Over the past 15 years, 85 PBL deals were signed in naval aviation, and 29 are still active, said Navy Vice Adm. David Architzel, head of Naval Air Systems Command.

Contractors remain optimistic that the market will take off once mistrust issues are worked out.
Accurate cost accounting is crucial in estimating whether outsourcing results in savings, said Tim Carey, vice president of Raytheon Space and Airborne Systems. “We have to make sure we’re doing the math the same way” in government and industry, he said at a Navy League conference.

The government could cut costs significantly by choosing the right performance metric for the maintenance of equipment, Carey said. A contract can be set up so that a company is paid $100 per flight hour, or it can compensate firms based on “mean time between failures” across the fleet.

The military’s aviation fleets should follow the lead of commercial airlines, which are embracing PBLs, said James W. O’Neill, vice president of Boeing Defense Space and Security.

“We kind of lost the art of communications and partnership over past years,” O’Neill said at the conference.

The PBL debate, however, ignores the underlying inefficiency in weapons maintenance and support. One impediment to reducing logistics expenses is that when weapon systems are purchased, long-term O&S costs are an afterthought. Procurement officials are rewarded based on their ability to manage their acquisition budgets, not on whether the system they are buying will saddle the Pentagon with huge “life-cycle costs” years or decades later.

Another reason why O&S costs have been on an upward curve is that Pentagon program managers don’t have the means to predict those expenses accurately. Current software tools such as computer models and simulations are “entirely inadequate to predict sustainment cost 20 years from now,” a senior Defense official said.

On average, O&S bills account for 60 to 70 percent of the entire cost of owning a weapon system over its entire lifetime, which in most cases can be several decades.

Undersecretary of Defense for Acquisition, Technology and Logistics Frank Kendall warned in a recent memo to his staff that the culture needs to change so that O&S costs become a higher priority when new weapon systems are acquired.

The most recent Defense Acquisition Board reviews of major systems have included discussions of O&S costs, said industry sources. One caveat, an industry expert said, is that the projected costs tend to be based on “models with questionable validity. … They can make the number anything they want it to be.”

Kendall, for his part, has asked the entire Pentagon acquisition work force to tighten their belts. In the memo, he said PBL contracts should be considered among other methods of achieving cost savings “while improving readiness.”

Dryden will be spearheading a “next-generation PBL” team to help guide program managers, Kendall wrote. “Developing correctly structured, priced, and executed PBLs is often a more complex task than initiating a standard transactional arrangement.”

Kendall also is a proponent of the Pentagon buying the “technical data package” of a weapon system from the manufacturer as a means to save O&S expenses down the line. The system’s blueprints then can be shared with multiple companies that will then compete for maintenance work. The TDPs of many of today’s weapon systems are owned by the manufacturer, which gives it an upper hand for future logistics work.

Many industry executives have privately complained that the new TDP policy removes one of the few lucrative opportunities for weapon manufacturers.

In the contract that the U.S. Air Force awarded to The Boeing Co. to build the new KC-46 aerial refueling tanker, the data rights were negotiated in the competition. The TDP was priced before the award, when the government was in a position to get the best deal. The Pentagon has less leverage to secure TDPs of existing weapon systems, although efforts are under way by the Air Force to acquire more TDPs for military aircraft components and airframes.

Manufacturers of unmanned aerial vehicles are in ongoing discussions with the Air Force about future O&S work. As the end of current wars approaches, the military plans to buy fewer new UAVs but expects to continue to fund O&S work. According to several industry sources, the Air Force is working with UAV producers to set up partnerships with government-owned Air Logistics Centers. At the time when the Air Force began purchasing UAVs in large quantities a decade ago, the technical data rights to aircraft designs were retained by the manufacturers.

The culture of Pentagon procurement, more so than technical data rights or PBLs, might be the biggest impediment to reducing costs, government and industry officials said.

Greater efficiency in logistics in fact might not be welcome by some Pentagon bureaucracies that could stand to lose funding and people if equipment readiness rates soared. That could turn PBL into a double-edged sword for industry.

Improved logistics support and readiness also could threaten a program office’s procurement funding, if it turns out that fewer systems will be required to sustain the fleet. The official who spoke off the record to industry executives warned them that trying to persuade the government to save money via PBLs, in some cases, might work against them. If industry convinces the government that it can keep larger numbers of aircraft and vehicles in service, the Pentagon might conclude that it needs to buy fewer of them, he said, “That’s a big threat to a program.”