

**REPORT OF THE  
DEFENSE SCIENCE BOARD  
TASK FORCE**

**ON**

**OUTSOURCING AND PRIVATIZATION**



**AUGUST 1996**

**Office of the Under Secretary of Defense for  
Acquisition and Technology**

**Washington, D.C. 20301-3140**

This report is a product of the Defense Science Board (DSB). The DSB is a Federal Advisory Committee established to provide independent advice to the Secretary of Defense. Statements, opinions, conclusions and recommendations in this report do not necessarily represent the official position of the Department of Defense.



DEFENSE SCIENCE  
BOARD

## OFFICE OF THE SECRETARY OF DEFENSE

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28 AUG 1996

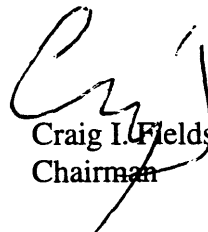
### MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (ACQUISITION AND TECHNOLOGY)

SUBJECT: Report of the Defense Science Board Task Force on Outsourcing and Privatization

I am pleased to forward the final report of the Defense Science Board Task Force on Outsourcing and Privatization, which was chaired by Philip A. Odeen and co-chaired by Morton Meyerson. This study was chartered to develop recommendations on ways DoD could use outsourcing as an important tool to free up substantial funds to support defense modernization needs.

The Task Force's key findings are summarized in the attachment, which responds to the specific questions raised in the Task Force Terms of Reference. While the Services and Defense Agencies are making progress in developing outsourcing programs, a broader, more aggressive outsourcing effort is needed. A clearer, more focused set of policies and programs are required to take full advantage of the potential to use outsourcing to reduce costs and enhance the effectiveness of the Department's support activities. Finally, support from the Executive Branch and the Congress is needed if DoD is to exploit fully the rapidly evolving outsourcing resources of the commercial sector.

I concur with the Task Force's conclusions and recommendations regarding the broad use of outsourcing in DoD. The savings potential is very great -- \$10 billion or more in annual savings by the year 2002. Moreover, the recommendations provide a number of positive steps toward a higher quality and more responsive support structure, which will provide the war-lighter with the support needed to achieve maximum advantage on the battlefield. As you know, this support structure for the 21st Century forces was outlined in the recently completed 1996 DSB Summer Study. This Task Force is fully supportive of and consistent with that effort.

  
Craig I. Fields  
Chairman

Attachment





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August 27, 1996

Memorandum for Chairman, Defense Science Board

**Subject: Final Report of the Defense Science Board Task Force on Outsourcing and Privatization**

Attached is the final report of the Defense Science Board Task Force on Outsourcing and Privatization. This DSB Task Force was charged to develop recommendations for ways DoD can use outsourcing as a tool to reduce the cost of the support structure while simultaneously enhancing support effectiveness. The Task Force addressed all aspects of the Terms of Reference and broadened the assessment to cover other related areas of relevance to DoD. The report in draft was discussed with a number of senior officials in OSD and the Services. Whenever possible, we incorporated their comments. The report has also been reviewed by Dr. Jacques Gansler and Mr. Robert Parker, and their suggested changes have been made.

Outsourcing is expanding rapidly in the private sector, and a robust new industry has developed to provide a wide range outsourcing services to U. S. companies (revenues are estimated at \$100 billion per year). While cost savings are a factor in the growth of outsourcing, access to better technology and better qualified people is the primary reason. Moreover, many companies have turned to outsourcing to free up the time and energies of management to focus on the companies' core competencies. Public sector entities at the state and local level as well as at the Federal level have demonstrated the value of outsourcing in terms saving money (30% plus savings) and providing better, more responsive service.

The Task Force believes that all DoD support functions should be contracted out to private vendors except those functions which are inherently governmental, are directly involved in warfighting, or for which no adequate private sector capability exists or can be expected to be established. Most defense agencies are prime outsourcing candidates. Specifically, the Task Force recommends that DoD consider outsourcing major portions of the Defense Commissary Agency (DeCA), the Defense Information Systems Agency (DISA), and the Defense Finance and Accounting Agency (DFAS) as initial steps toward streamlining DOD'S support infrastructure. Many support functions performed primarily by military personnel (e.g., individual training and support services in military hospitals) are also ripe for outsourcing.





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Chairman, Defense Science Board  
August 27, 1996  
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The Task Force is convinced that an aggressive DoD outsourcing initiative will improve the quality of support services at significantly reduced costs. In fact, the Task Force recommends that the Secretary of Defense set a target for the year 2002 to generate up to \$10 billion or more in outsourcing related savings to fund the badly needed expansion of investment programs for DoD. This will require:

- Changes in Defense policies and procedures to facilitate outsourcing
- Relief from legislative impediments and regulatory constraints
- Improvements in Defense contracting procedures and incentives to encourage greater reliance on outsourcing.

As we stated in our DSB Summer Study report last year, "A revolution in DoD business affairs is needed to pay for the revolution in DoD military affairs." I believe this report provides a blueprint for a major element of that revolution and will serve as a key factor in DoD'S effort to build a 21 st Century support structure as recommended by the 1996 DSB Summer Study.

We would like to thank the Task Force members and the government advisors for their hard work on this report. In addition, we commend the support of Dr. Goodman and his staff (especially Julia Vindasius), the DSB secretariat, and the contractor support provided by Coopers & Lybrand and TASC. The quality of this report is a direct result of their contributions.

A draft letter to Dr. Kaminski is enclosed for your use in forwarding the report. If you have questions, please contact me.

Philip A. Odeen  
Chairman

PAO/mrm

Enclosure



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# **Defense Science Board Task Force on Outsourcing and Privatization**

## **Final Report**

August 1996

## **Task Force Policy Goal**

This annotated briefing summarizes the findings and recommendations of the Defense Science Board (DSB) Task Force on Outsourcing and Privatization. The Task Force was established at the request of Dr. Paul Kaminski, Under Secretary of Defense (Acquisition and Technology), and performed its work from October 1995 to August 1996.

Department of Defense DoD funding for equipment modernization has declined steadily in recent years, the result of budget constraints and the conclusion of the Cold War. In constant FY96 dollars, procurement has fallen from a peak of \$126 billion in FY85 to only \$39 billion in FY96 -- a reduction of 69 percent.' Today, procurement accounts for only 18 percent of total DoD budget resources. Both the Secretary of Defense (SecDef) and the Chairman of the Joint Chiefs of Staff (CJCS) have stated that funding levels for modernization must increase substantially in the coming years if DoD is to procure the new high technology weapons it will need in the 21st century.

In contrast, DoD continues to maintain a vast, in-house support infrastructure to house, train, equip, and manage its fighting forces. This infrastructure consumes a large and growing share of total DoD resources. Moreover, there is abundant evidence that support services purchased with these funds are in many cases more costly and less responsive than comparable services provided by the private sector.

Top-line defense budgets are not likely to increase significantly in the short- to mid-term, and may well decline. In order to increase funding for equipment modernization, DoD must therefore shift resources from support to procurement. In the view of the Task Force, DoD can only achieve this transfer of resources by discarding its traditional reliance on in-house support and implementing an aggressive strategy to outsource most support services.

The Task Force believes that an aggressive DoD outsourcing initiative could generate savings of up to \$7 to \$12 billion annually by fiscal year 2002 (FY02) -- resources which then would be available for equipment modernization. Without such an initiative, the Task Force is concerned that DoD may not be able to procure the new weapon systems and technological edge needed to ensure the continuing military preeminence of the United States in the coming century.

This report outlines a strategy for reaching this ambitious but achievable goal, and addresses other issues discussed above.



# Task Force Policy Goal

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- **Shift \$7-\$12 B per yr from support to modernization by FY 2002**
  - Provide modernization funding seen as essential by SecDef & CJCS
  - Key to preserving superiority of U.S. military technology & force effectiveness

*DoD needs a revolution in business affairs to support the revolution in military affairs.*

## Briefing Outline: Background

This report includes the following major sections:

**Background** provides general information on the membership, organization, and objectives of the Task Force. This slide introduces the Background section.

**The Challenge** documents the growth in support costs as a percentage of total DoD resources, discusses the size and composition of the DoD support structure, and describes the Task Force vision of a new DoD approach to acquiring support services.

**Private Sector Experience** summarizes private sector outsourcing trends, strategies, and outcomes.

**Public Sector Experience** discusses the results of outsourcing actions already undertaken by public sector organizations, including DoD

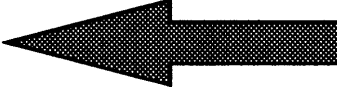
**Primary Impediments** identifies the major statutory, administrative, and cultural obstacles to outsourcing DoD support functions.

**Proposed Strategy** describes the Task Force's proposed strategy and goals for an aggressive DoD outsourcing initiative.

**Recommendations** describes detailed actions needed to implement the proposed outsourcing strategy, and identifies specific support functions that should be transferred immediately to private vendors.

# Briefing Outline

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- ❑ **Background** 
- ❑ The Challenge
- ❑ Private Sector Experience
- ❑ Public Sector Experience
- ❑ Primary Impediments
- ❑ Proposed Strategy
- ❑ Recommendations

### **Background: Task Force Objective**

The Task Force objective was to develop an aggressive outsourcing strategy to improve the quality of DoD support services at significantly reduced cost.

The Task Force does not view outsourcing primarily as an end to itself, but as the only practical approach to freeing up the resources needed to ensure the continuing military superiority and technological leadership of the U.S. armed forces.

The Task Force believes that, as a matter of principle as well as for reasons of sound policy, all DoD support activities that are commercial in nature should be provided by private vendors. The private sector is the primary source of creativity, innovation, and efficiency in our society, and is more likely than government organizations to provide cost-effective support to the Nation's military forces. Moreover, government should not be in the business of competing with its own citizens to provide support services that can be performed effectively by the private sector.

The Task Force's view is fully consistent with the official policy of the Federal Government. The Bureau of the Budget (the predecessor organization of the Office of Management and Budget (OMB)) declared in 1955 that "the Federal Government will not start or carry on any commercial activity...for its own use if such product or service can be procured from private enterprise."<sup>2</sup> This policy remains in force today.

The Task Force seeks to bring DoD practice in line with official policy so that the Department may benefit fully from the capabilities and creativity of the private sector.

# Background:

## Task Force Study Objective

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- ❑ **Develop an aggressive outsourcing strategy that improves the quality of DoD support services while greatly reducing their cost**

*Outsourcing savings must be used to preserve the superiority of U.S. military technology & force effectiveness.*

### **Background: Task Force Participants**

This slide identifies Task Force members and other participants, including Military Service and Defense Agency representatives and DoD staff.

The Task Force Chairman was Mr. Phil Odeen, President and Chief Executive Officer (CEO) of BDM International, Inc. Mr. Mort Meyerson, CEO and Chairman of Perot Systems Corporation, served as Task Force Vice Chairman. Ms. Julia Vindasius of the Office of the Secretary of Defense served as the Executive Secretary of the Task Force.

Task Force members include leading executives of major defense- and commercial-oriented companies, retired senior military officers with substantial knowledge of DoD support functions and operational requirements, and outside experts with extensive experience in outsourcing issues. DoD representatives participated fully in all Task Force deliberations.

Brian Dickson of Coopers & Lybrand, L.L.P. and Lois Lembo of TASC, Inc. provided contractor support to the Task Force under the sponsorship of Mr. John Goodman, Deputy Under Secretary of Defense (Industrial Affairs and Installations).



## **Background: Task Force Organization**

This slide summarizes the organization and general approach of the Task Force on Outsourcing and Privatization. Throughout its deliberations, the Task Force sought a broad range of input from private sector and government representatives to ensure that its recommendations are based on sound information and analysis.

As noted above, the Task Force included defense industry executives, private sector experts, and DOD/Service representatives. The Task Force held three 1 1/2 day plenary meetings (October 1995, December 1995, and January 1996) to gather general background information and discuss proposed themes of the Task Force report.

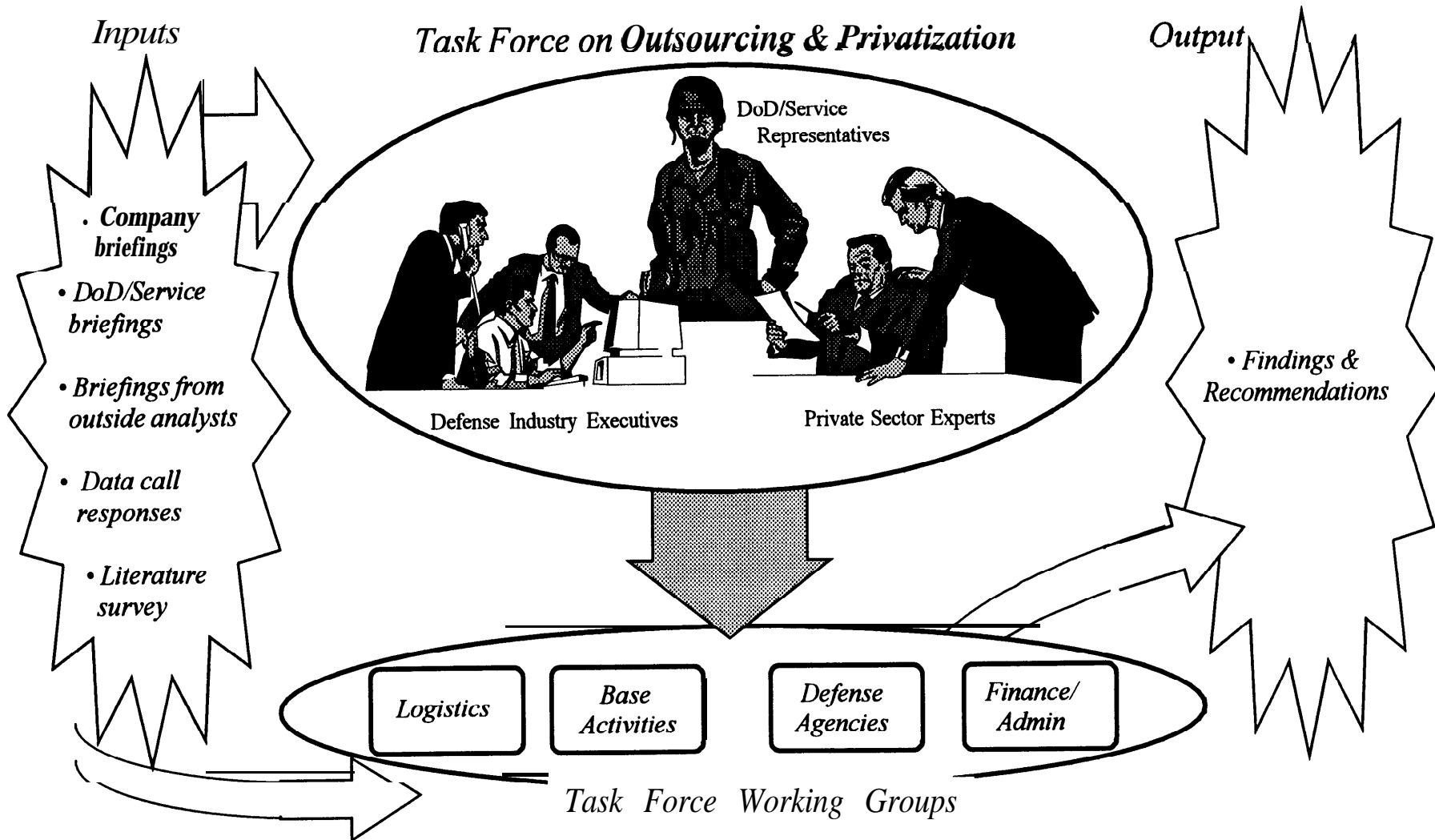
At these meetings, the Task Force received briefings from DoD representatives involved in the Department's ongoing outsourcing initiative; outside analysts with expertise in outsourcing issues; and government and industry representatives with practical experience as procurers or providers of outsourced support services. Task Force participants also reviewed a range of journal articles and other relevant literature on outsourcing trends, outcomes, and implementation issues.

In addition, the Task Force divided into four subcommittees: logistics; base activities; finance and administration; and defense agencies and other support functions. These subcommittees held meetings and conducted research to assess the potential for outsourcing in the four functional areas. The subcommittees met with the senior leadership of the defense agencies and activities that perform support functions in these areas, as well as representatives of private sector firms that provide comparable services to government and commercial clients.

As a result of these efforts, the subcommittees developed draft findings and recommendations for Task Force review at the January 1996 meeting. These materials formed the basis of a draft report which was discussed in detail with senior OSD, Service, and defense agency officials. The Task Force carefully considered the comments of these senior officials in the course of developing its final recommendations.



# Background: Task Force Organization



## Background: Key Questions

This slide identifies specific questions posed by Under Secretary Kaminski in the Task Force Terms of Reference. The following discussion summarizes the Task Force responses to these questions. These issues are addressed in greater detail throughout this report.

**What DoD functions should be performed by the private sector? What are the priorities for action?** The Task Force believes that all DoD support services should be contracted out to private vendors except those functions which are inherently governmental or directly impact war-fighting capability, or for which no adequate private sector capability exists or can be expected to be established. Most defense agencies are prime outsourcing candidates. Specifically, the Task Force recommends that DoD consider outsourcing major portions of the Defense Commissary Agency (DeCA), the Defense Information Systems Agency (DISA), and the Defense Finance and Accounting Service (DFAS) as initial steps toward streamlining DoD's support infrastructure. Many support functions performed primarily by military personnel (e.g. individual training) are also ripe for outsourcing.

**What savings and quality improvements may be achieved through outsourcing and privatization?** DoD can realize savings of 30 to 40 percent of function costs by outsourcing support services traditionally performed by government personnel. The Task Force believes that an aggressive DoD outsourcing initiative could generate total annual savings of \$7 to \$12 billion by FY02. The transfer of support functions to outside vendors is also likely to result in broad improvements in service delivery and responsiveness.

**Which incentives would encourage DoD to move toward a greater reliance on the private sector for support services? DoD** must take appropriate measures to ensure that the Services retain outsourcing savings for their own use. Local commanders that achieve outsourcing objectives should be rewarded with promotions and desirable assignments. Senior DoD officials should take full advantage of their authority to waive A-76 requirements **and** aggressively seek to eliminate legal restrictions that discourage outsourcing.

**What contract terms and conditions will encourage or discourage the private sector?** DoD service contracts should include performance-based incentives to encourage vendors to reduce costs and improve service delivery. DoD should provide long-term contracts (five to ten years), but include cancellation clauses for poor performance. Oversight should be performed by a small cadre of functional experts who establish a collaborative rather than antagonistic relationship with the vendor.

**What are the "lessons learned," including personnel, process, and organizational issues?** In the private sector, outsourcing is a top-down process that requires the personal involvement of senior executives. Senior DoD officials must also play a highly active and visible role in the Department's outsourcing initiative and take full advantage of their authority to waive A-76 requirements. A senior OSD official should serve as the Department's focal point for outsourcing issues. DoD managers must be held accountable for meeting outsourcing objectives.

**What near-term actions should DoD take?** The Secretary of Defense should articulate a clear policy favoring outsourcing of most support functions. The Services should establish concrete outsourcing targets and milestones. Senior DoD officials should create a Tiger Team to improve the DoD's service contracting capabilities and seek passage of proposed legislation to eliminate legal barriers to outsourcing. DoD should initiate efforts to outsource a range of support functions that are widely available in the private sector.

# Background: Key Questions

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- ❑ What DoD functions should be performed by the private sector? What are the priorities for action?
- ❑ What savings and quality improvements may be achieved through outsourcing and privatization?
- ❑ Which incentives would encourage DoD to move toward a greater reliance on the private sector for support services?
- ❑ What contract terms and conditions will encourage or discourage the private sector?
- ❑ What are the “lessons learned,” including personnel, process, and organizational issues?
- ❑ What near-term actions can DoD take to accelerate the process?

## Background: Definitions

Throughout this report, the Task Force utilizes the term “outsourcing” as a general concept that incorporates the narrower case of “privatization.”


“Outsourcing” refers to the transfer of a support function traditionally performed by an in-house organization to an outside service provider. Outsourcing occurs in both the public and private sectors. While the outsourcing firm or government organization continues to provide appropriate oversight, the vendor is typically granted extensive flexibility regarding how the work is performed. In successful outsourcing arrangements, the vendor utilizes new technologies and business practices to improve service delivery and/or reduce support costs. Vendors are usually selected as the result of a competition among qualified bidders.

“Privatization” is a subset of outsourcing which applies only to the public sector. Privatization actions involve not only the contracting out of support functions, but also the transfer of facilities, equipment, and other government assets to private vendors. Government organizations often outsource support functions without privatizing public assets.

In the view of the Task Force, most DoD outsourcing initiatives are not likely to involve significant asset transfers. Accordingly, the Task Force focused its analysis on the general concept of outsourcing.

# Background: Definitions

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- **Outsourcing**  *Task Force Focus*
- Transfer of a support function previously performed in-house to an outside service provider
  - Service provider usually given extensive flexibility regarding how it performs the outsourced function
- **Privatization**
- A type of outsourcing involving the transfer of government assets (depots, data centers, etc.) to the private sector
  - Government sheds capability to perform the outsourced task
  - Most DoD outsourcing initiatives do not involve privatization

### **Briefing Outline: The Challenge**

This section underscores the critical importance of reducing DoD support costs, provides an overview of the vast DoD support structure, and summarizes the key elements of an aggressive DoD outsourcing strategy.

# Briefing Outline

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- ❑ Background
- ❑ **The Challenge** 
- ❑ Private Sector Experience
- ❑ Public Sector Experience
- ❑ Primary impediments
- ❑ Proposed Strategy
- ❑ Recommendations

## The Challenge: Overview

Deputy Secretary of Defense John White recently characterized the serious resource challenge facing DoD:

“We have [completed] a successful drawdown of the force. I think we have done a good job of managing that both in terms of people, most importantly, but also in terms of weapons and capabilities. We are now in a situation where we have to expand. We have to grow from some \$39 billion in our [procurement] account in the current year to, in terms of the five year program, about \$68 billion. That is a very, very big challenge.”

As the Deputy Secretary's remarks suggest, the current pace of equipment modernization is insufficient to sustain our military forces over the long term. Modernization funding declined steadily during the last decade, in part due to heavy investments in military equipment made during the 1980s. While DoD is well-equipped to meet any anticipated contingency today, current procurement levels are not sufficient to modernize the existing inventory of aircraft, ships, and other military systems. Early in the next century, much of this inventory will be 20 years old or more.

Because of deficit reduction efforts and competing national priorities, top-line defense budgets are not likely to grow significantly in the coming years -- and, indeed, may continue to decline in real terms. Accordingly, additional modernization funding will have to come from DoD's existing pool of resources. There are three potential sources of additional funds: further force structure reductions, additional base closures and other infrastructure consolidation, and the streamlining of support functions.

The Task Force believes that modernization should not be funded out of further reductions in the DoD force structure. Presentations to the Task Force by senior military and civilian officials emphasized that further downsizing of our military forces beyond current planned levels appears impractical and unwise in light of continuing global tensions and instability.

DoD is also unlikely to obtain significant additional resources for modernization from further infrastructure consolidation, at least in the mid-term. The Base Closure and Realignment (BRAC) Commission completed its most recent round of base closure actions in 1995. While the BRAC process is for the first time generating net savings in 1996 (transition costs of base closure actions are often high), these savings have already been incorporated into the current Five Year Defense Plan (FYDP). Moreover, Congressional interest in authorizing another BRAC round anytime soon is open to question.

In the opinion of the Task Force, DoD is left with only one practical alternative to meet its future modernization requirements: sharply reduce DoD support costs, and apply the savings to the procurement account. The Task Force firmly believes that extensive savings can be achieved -- if DoD is willing to abandon its traditional reliance on in-house support organizations in favor of a new support paradigm that capitalizes upon the efficiency and creativity of the private sector.



# The Challenge:

## Overview

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*To afford critically needed modernization, DoD must reduce its infrastructure & support costs!*

- ❑ Defense budgets are not likely to grow significantly -- and may continue to contract
- ❑ Current pace of equipment modernization is inadequate to preserve the technological edge of U.S. military forces
- ❑ Further reductions in force structure entail risk
- ❑ Further base closures unlikely in mid-term
- ❑ **The challenge:** free resources for modernization by dramatically reducing support costs

### **The Challenge: Declining Resources for Modernization**

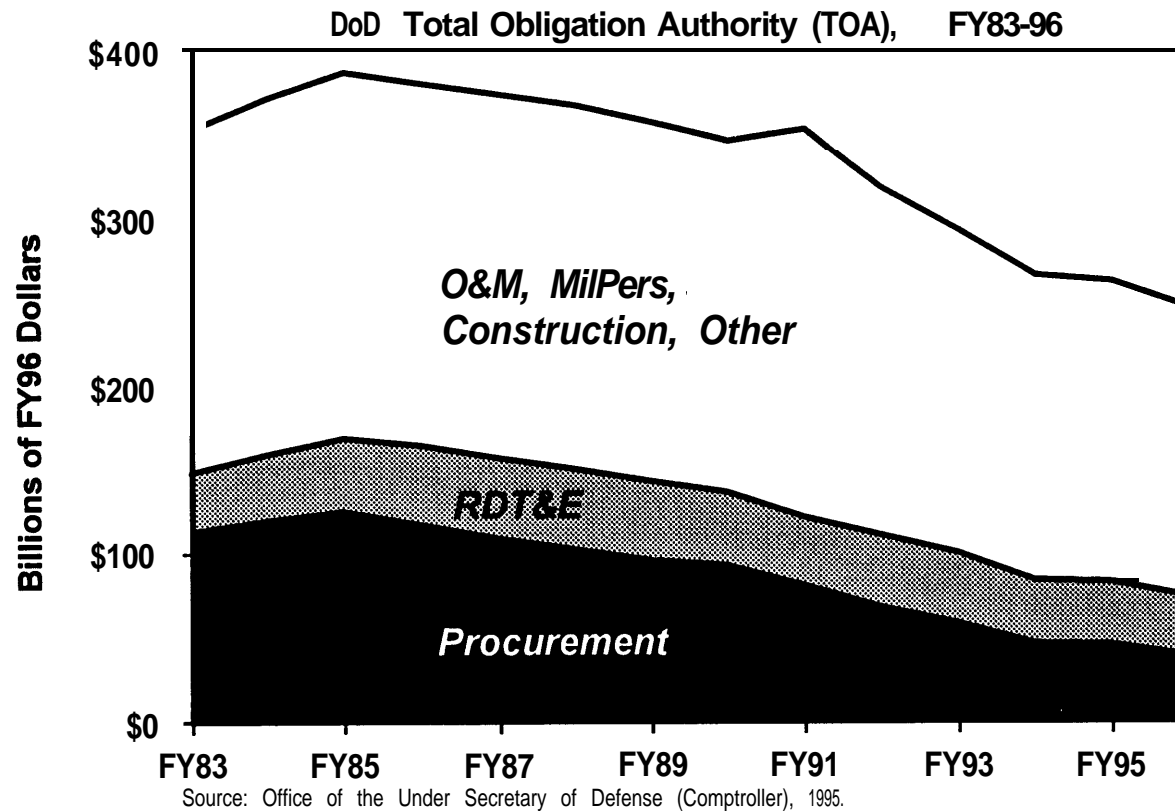
This slide shows the declining share of DoD resources devoted to procurement, and the relative stability of other DoD accounts.

As noted above, funding for equipment modernization has fallen from a peak of \$126 billion in FY85 to only \$39 billion in FY96 -- a decline of 69 percent. In contrast, other DoD accounts declined in aggregate only 20 percent during this same period. As a result, modernization represents a diminishing share of total DoD resources, from 33 percent of total obligational authority in FY85 to only 18 percent today.

DoD budget data provide incomplete visibility into the total costs associated with support operations, as the military personnel account includes both war-fighters and service personnel employed in non-combat support roles. However, it is estimated that support functions such as base support, equipment maintenance, individual training, and health care now account for 40 to 50 percent of total defense budget resources.

In other words, DoD's support infrastructure has remained largely impervious to downsizing, despite significant reductions in force structure in recent years. The Task Force believes that the Department should implement an aggressive outsourcing strategy to streamline this costly and outmoded infrastructure.

# The Challenge: Declining Resources for Modernization



*Procurement funding declined 69% from 1985-96; was 33% of budget authority in 1985 -- only 18% today.*

## The Challenge: Large DoD Support Structure

This slide provides an overview of the DoD support infrastructure, including staffing levels for the major defense agencies/activities and manpower data on the number of DoD military and civilian personnel engaged in commercial-type activities. DoD should divest much of this infrastructure and transfer most of these support functions to qualified outside vendors.

**Defense agencies/activities:** The bar chart on the left identifies the personnel strength of major defense agencies and related organizations.<sup>4</sup> Defense agencies and activities perform common support functions for the military services, most of which are commercial in nature and have considerable potential for outsourcing. These support organizations are staffed primarily by civilians. The defense agencies and related organizations have a total staff of about 310,000 personnel. The Defense Health Program (DHP) is the largest support entity with a staff of 148,000. The DHP's mission is to provide health care services to military personnel, dependents, and retirees.

The Defense Logistics Agency (DLA) has a staff of approximately 52,000, and serves as the inventory manager for most consumable items, the distributor/warehouse of all DoD wholesale inventories, and the contract manager for almost 400,000 prime contracts. In recent years, DLA has moved aggressively to outsource a significant portion of its workload in the material management area -- with dramatic results. However, the Task Force believes that further opportunities should be exploited in this area.

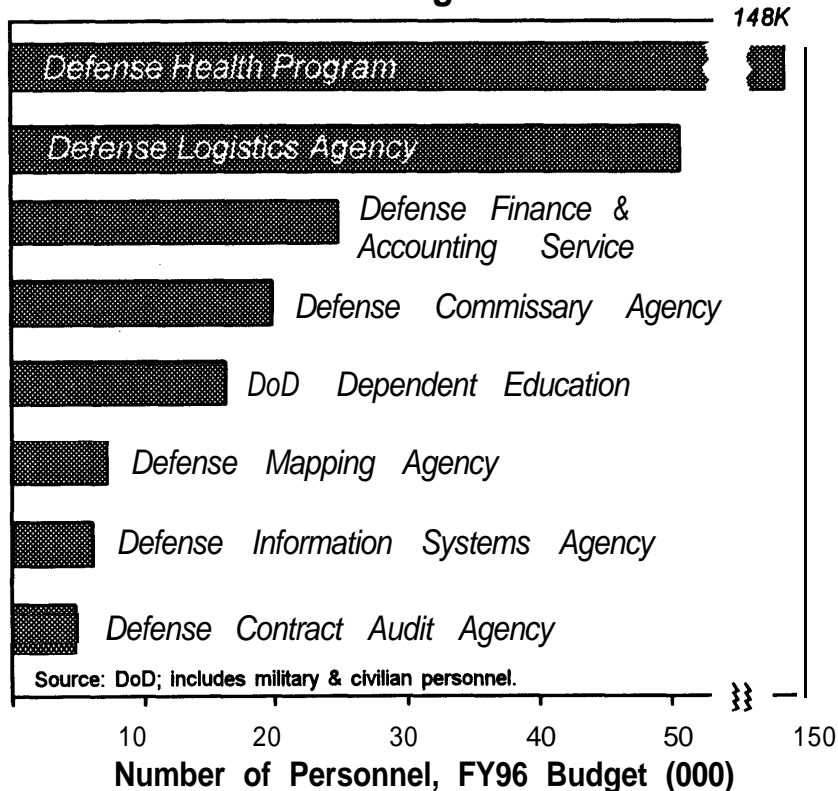
The Defense Finance and Accounting Service (DFAS), the Defense Commissary Agency (DeCA), and the DoD Dependent Education Activity (DODEA) are large DoD support organizations -- each with 15,000 to 25,000 workers -- which perform services that are widely available in the private sector. As noted in later sections of this report, the Task Force recommends that DoD initiate action to outsource many of these functions. The Defense Information Systems Agency (DISA), which performs telecommunications and data processing functions for the military services, is also an attractive candidate for early outsourcing.

**Commercial activities:** The table on the right identifies the number of DoD full-time equivalents (FTEs) performing commercial-type activities as reported by DoD components to the DoD Commercial Activities Inventory Data Base for FY94.5 (FY95 data show a significant decline in the number of FTEs involved in "commercial" activities, largely because of a reclassification of certain occupational categories from commercial to non-commercial activities. Therefore, the Task Force believes that the FY94 data is more representative of the actual number of FTEs in commercial-type activities--and, as noted below, even the FY94 figures may be understated.) Of the 640,000 FTEs involved in commercial activities in FY94, over one third are performing depot-level or intermediate maintenance. Base services and health services are the other major sources of commercial activity FTEs. These categories account for almost three quarters of all commercial FTEs. Military readiness requires that some of the commercial activity workload performed by military personnel deployed in combat units should remain in-house. However, the private sector could easily perform the bulk of this commercial-type work -- probably at lower cost and superior quality.

There is strong evidence that the number of DoD personnel actually engaged in commercial-type activities greatly exceeds the 640,000 total. There are over 800,000 civilians employed by DoD but only 337,000 show up in the database. Presumably, contractors could perform most of the work currently executed by these civilian employees. Moreover, DoD sources indicate that there are about 67,000 DoD personnel involved in individual training -- not 17,000 as indicated in the database. The Task Force urges DoD to take appropriate measures to ensure the completeness and accuracy of the DoD Commercial Activities Inventory Data Base.

# The Challenge: Large DoD Support Structure

Selected Defense Agencies/Activities



DoD Personnel Performing Commercial-Type Activities

Activity/Occupation	# Civ (000)	# Mil (000)	TTL (000)	%
Maint/Repair	112	103	215	34%
Base Services	75	60	135	21%
Health Services	40	71	111	17%
Maint/Real Prop	25	10	35	5%
Social Services	22	7	29	5%
Educ/Training	4	13	17	3%
Data Processing	12	5	17	3%
Other	47	33	80	13%
<b>TOTAL</b>	<b>337</b>	<b>303</b>	<b>640</b>	<b>100%</b>

Source: DoD Commercial Activities Database, 1994.

*640K total excludes many personnel involved in commercial tasks; for example, 67K DoD personnel deliver/support individual training.*

## The Challenge: Proposed Outsourcing Strategy

This slide summarizes the key elements of an innovative and aggressive strategy to greatly reduce DoD's organic support infrastructure.

DoD's current approach to outsourcing is governed primarily by Office of Management and Budget (OMB) Circular A-76, which requires Federal agencies to perform exhaustive public/private cost comparisons before outsourcing functions traditionally performed by government employees." A-76 public/private competitions are extremely time-consuming, biased in favor of the government entity, and concentrated in narrow, labor-intensive support functions involving relatively small numbers of government employees. In practice, the premise of A-76 is that support functions should be performed by government organizations unless there is a compelling reason to transfer the workload to the private sector.

The Task Force proposes a dramatic departure from the current reliance on A-76. DoD should reverse the current presumption in favor of organic support; vendors should provide all support unless there are compelling reasons for the workload to remain in-house. DoD and the Military Services should take full advantage of existing waivers and exemptions to avoid time-consuming and unfair public/private competitions imposed by A-76. To date, DoD reportedly never has exercised its waiver authority or claimed a national defense exemption as permitted by existing A-76 rules. For some support functions, the Task Force also believes that DoD can avoid A-76 jurisdiction by making top-down policy decisions to "get out of the business" of performing such services. For example, DLA successfully used this approach to transfer the pharmaceutical warehousing and distribution functions to vendors. Business case analysis, rather than public/private competition, should be used to identify outsourcing candidates.

This top-down strategy will encourage DoD to outsource broad business functions, including high cost, "high tech" functions, providing outside vendors with the greatest opportunity to reengineer business processes and improve service delivery. In the view of the Task Force, this aggressive approach to outsourcing could result in savings of 40 percent or more of function costs, as well as significant improvements in service quality.

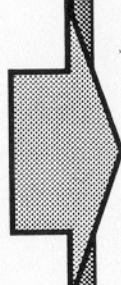
Even if DoD adopts this strategy, the Department may in some cases still need to comply with A-76 procedures for legal and/or political reasons. Accordingly, DoD should work to revise or eliminate A-76 requirements that inhibit outsourcing and develop more equitable and timely methods for conducting public/private cost comparisons.

The issues raised above are discussed in greater detail throughout this report.

# The Challenge: Proposed Outsourcing Strategy

## Current Approach

- ❑ Support performed in-house absent compelling reason to outsource
- ❑ Cumbersome A-76 process governs outsourcing
  - requires public/private competition
- ❑ Suboptimal results
  - mostly small, stovepipe functions
  - playing field not level
  - focus on low-tech functions
  - takes too much time
- ❑ A-76 complexity, bias against vendors, up-front costs discourage outsourcing
- ❑ Statutory restrictions, Congressional micromanagement



## Proposed Strategy

- ❑ Support performed by vendor absent compelling reason to retain in-house
- ❑ Greatly reduce reliance on A-76 public/private competitions
  - A-76 waivers/exemptions
  - top-down policy decisions to “get out of business”
  - business case analysis
- ❑ Outsource broad functions, use as tool to reengineer support services
  - capitalize on innovation & efficiency of market forces
- ❑ Use improved cost comparison techniques when public/private competitions are necessary
- ❑ Move aggressively to eliminate statutory/institutional barriers

### **Briefing Outline: Private Sector Experience**

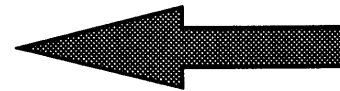
This section provides an overview of private sector outsourcing trends and outcomes, and identifies **key** outsourcing lessons gathered **from** the Task Force's discussions with representatives of both outsourcing firms and service providers.



# Briefing Outline

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- Background
- The Challenge
- Private Sector Experience
- Public Sector Experience
- Primary Impediments
- Proposed Strategy
- Recommendations



### **Private Sector Experience: Overview**

Private sector firms increasingly outsource a wide range of support functions to outside vendors. Information technology (IT) was the first major function to be outsourced beginning in the mid-1980s. Today, IT outsourcing still represents a major share of all outsourcing activity. Business logistics, manufacturing, and finance and administration are other support functions with strong outsourcing trends.

The Outsourcing Institute is a private, non-profit research organization that analyzes outsourcing trends and outcomes, and provides advice to firms and other organizations considering the outsourcing of major business functions. According the Outsourcing Institute, U.S. firms will spend an estimated \$100 billion for outsourced services in 1996, saving an estimated 10 to 15 percent of total function costs.'

It is important to note that outsourcing savings are significantly higher in government organizations than the private sector. This differential reflects the relative efficiency of in-house support organizations in the private sector, as compared to their government counterparts.

The private sector initially viewed outsourcing primarily as a tool for reducing support costs. However, as companies have become more experienced with outsourcing, they have developed a broader view of its benefits. These benefits include the opportunity to concentrate resources on core capabilities, greater access to innovative technologies and business practices, and improved service quality and responsiveness.

The growth of outsourcing in the private sector has resulted in the emergence of a range of service industries with strong capabilities to support DoD. The Department should take advantage of every opportunity to leverage these private sector capabilities.

# Private Sector Experience: Overview

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- ❑ Outsourcing is expanding rapidly in the private sector across a wide range of business functions
- ❑ U.S. firms will spend an estimated \$100 billion on outsourcing in 1996, saving 10-15% of total function costs
  - Savings are higher in the public sector because of the inefficiency of government service organizations
- ❑ While viewed initially as a tool for cutting costs, firms increasingly rely on outsourcing to enhance capabilities
- ❑ The outsourcing trend has spawned new industries of service providers which can be leveraged by DoD

### **Private Sector Experience: Outsourcing Results**

Two recent industry surveys indicate that outsourcing is widespread in the private sector and provides a range of benefits to outsourcing firms.

As noted above, The Outsourcing Institute estimates U.S. firms will spend an estimated \$100 billion for outsourced services in 1996, saving approximately 10 to 15 percent of total function costs. According the Institute's 1995 survey, outsourcing firms have achieved significant improvements in the quality of support services, enhancing their ability to meet customer needs.<sup>8</sup> Surveyed firms indicate that they regard outsourcing not only as an effective tactic for reducing support costs, but also as a key element of their competitive strategy.

Moreover, a recent survey of over 300 senior executives in 50 multinational companies indicates that outsourcing is a commonly-used tool among such firms, with 85 percent already outsourcing all or part of at least one major business function -- a figure that is expected to grow to 93 percent by 1998. More than 90 percent of such firms believe that these outsourcing initiatives have been successful.<sup>9</sup>

Such studies are consistent with abundant anecdotal evidence and the strongly-held view of leading U.S. industry executives: outsourcing works, and is essential to maintaining competitiveness in today's marketplace. The appendix to this report contains an extensive list of articles on outsourcing by both private sector firms and government organizations.

# Private Sector Experience: Outsourcing Results

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## *Outsourcing Institute, 1994/95 -- Industry Surveys*

- ❑ Outsourcing viewed as essential to competitiveness
- ❑ Significant capacity and quality improvements achieved
- ❑ U.S. firms will obtain 10-15% average savings for outsourced functions in 1996

## *Arthur Anderson/Economist Intelligence Unit, 1995 Survey of 303 Senior Executives & 50 Global Firms*

- ❑ 85% of surveyed firms outsource all or part of at least one major business function -- will increase to 93% by 1998
- ❑ 91% of outsourcing firms satisfied with results

### Private Sector Experience: Functions Outsourced

U.S. industry regards outsourcing as an effective response to competitive pressures. A growing share of major U.S. and international companies outsource a broad range of support functions.

For example, a 1994 study of 100 *Fortune 500* corporations indicates that 77 percent of the firms studied had already outsourced or were in the process of outsourcing some aspect of their business support services. Business support services include back office operations such as records management and mailroom and copy center operations.<sup>10</sup>

In the Arthur Andersen/Economist Intelligence Unit survey referenced above, 42% of the companies surveyed outsourced pension management, followed by tax functions (40%) and payroll management (28%). Over the next 1-3 years, 63% of the companies expected to outsource pension management, 57% expected to outsource tax functions and 50% will outsource payroll.<sup>11</sup>

A recent survey of major hospitals indicates that two thirds of these institutions use outside service provider to perform the functions of at least one hospital department. Of those hospitals that outsource, 90% use outside providers for support services; 77% outsource some clinical services; and over half utilize contractors for business services.<sup>12</sup>

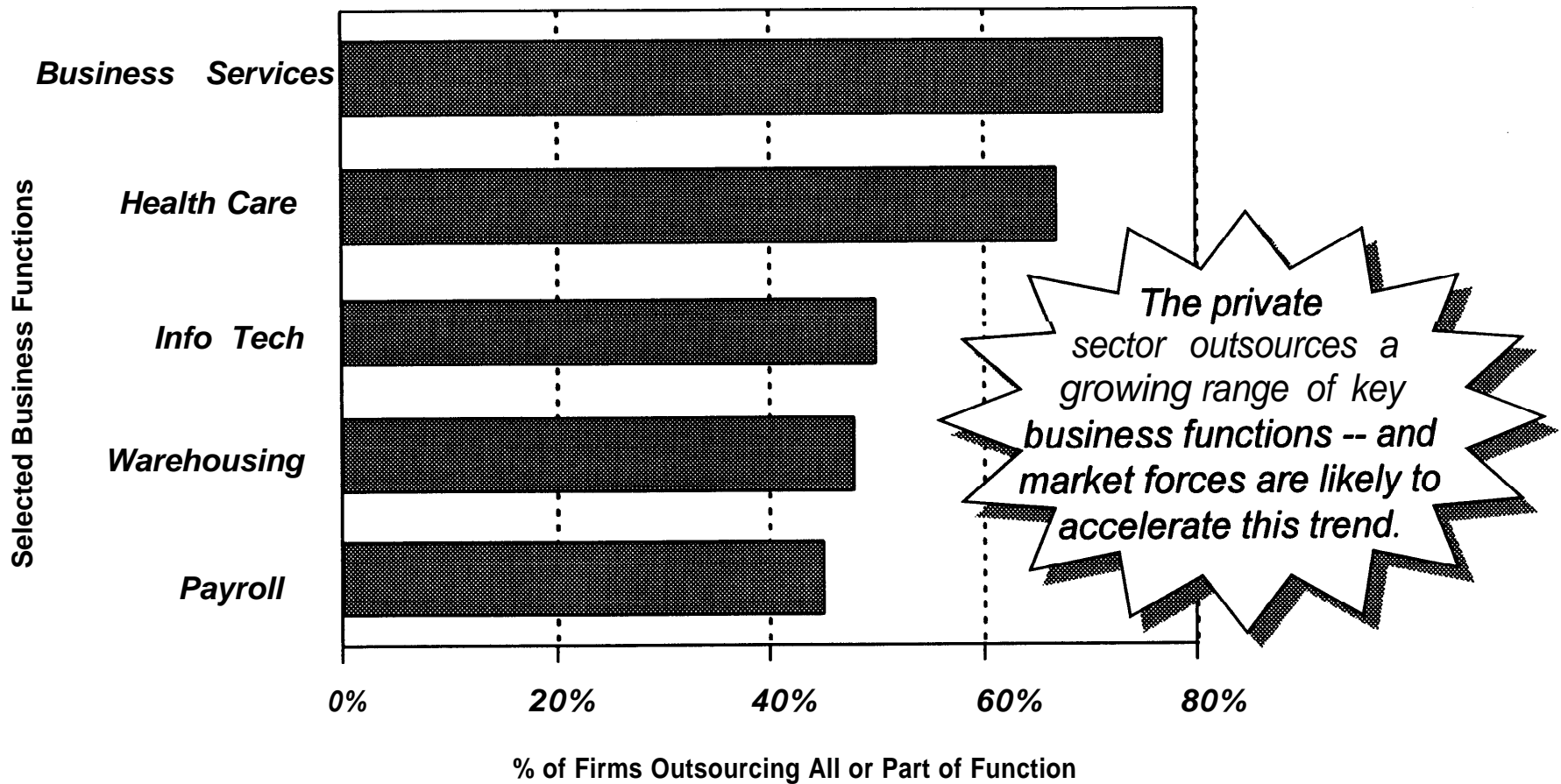
A 1992 survey of 1,200 firms found that one half of all companies with annual information technology (IT) budgets exceeding \$5 million are already outsourcing or are in the process of moving some IT functions to outside service providers.<sup>13</sup> Major IT functions include data center management, network management, systems management, and telecommunications. According to the survey, the IT outsourcing revenues totaled \$38 billion in 1995 -- and continue to grow rapidly. Information technology is the largest outsourcing market, accounting from one half to two thirds of all outsourcing activity.

Outsourcing is also a major force in the business logistics area. According to a 1994 survey of 309 *Fortune 1000* firms, 66 percent of firms outsource import/export services; 63 percent employ freight brokers for transport selection, carrier monitoring, insurance, tariff and customs compliance; 49 percent outsource freight audit services; and 48 percent use outside contractors for warehousing.<sup>14</sup>

The human resource departments in major U.S. corporations are also moving strongly to outsource key functions. According to a 1994 survey of 400 corporations conducted by the Olsten Corporation, 45 percent of firms outsource payroll management; 38 percent outsource tax administration; 35 outsource benefits management; and 34 percent outsource workers compensation.<sup>15</sup> In a 1995 survey of 121 businesses, HR Magazine found that 91% outsourced one or more of their HR functions, and 16% outsourced more than \$1m annually. Functions most frequently outsourced include: outplacement (64%) training delivery (46%), and training development (40%)<sup>16</sup>

Companies increasingly outsource training. According to a survey conducted by Training and Development Magazine, one third of the companies questioned reported that outsourcing had increased, almost half of those said outsourcing had increased by 25%. 78% outsourced training delivery, and 56% outsourced training consulting.<sup>17</sup>

# Private Sector Experience: Functions Outsourced



Source: Industry surveys as summarized by The Outsourcing Institute. See annotation and endnotes for citations. Survey results for information technology include firms with IT budgets of more than \$5 million that are currently outsourcing or actively considering it.

### Private Sector Experience: Reasons for Outsourcing

Outsourcing firms cite several reasons for shifting support functions to outside service providers, including a sharpened company focus on core businesses and capabilities; cost reduction and improved utilization of capital resources; improvements in the quality, responsiveness, and agility of internal services; improved access to new technology, including skilled workers; and one-time revenues through asset sales.

During the first 70 years of the twentieth century, the most powerful and successful companies in the United States were vertically integrated organizations. For example, U.S. Steel and General Motors operated as virtually self-sufficient entities, with large networks of in-house suppliers providing support services **as** well **as** parts and materials to the primary production facilities.

Today, successful firms require great agility to exploit emerging market opportunities. Outsourcing is a critical element of this agility, as it provides firms with greater flexibility to concentrate resources in response to changing market conditions. Even the vertically integrated monoliths of the 1930s, 1940s, and 1950s have long shed most secondary functions in an effort to maintain a competitive cost structure and improve their focus on core businesses.

In the private sector, outsourcing is not a bold new concept, but a necessity for survival in the marketplace.



# Private Sector Experience: Reasons for Outsourcing

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- Permit greater focus on core competencies
- Improve service quality, responsiveness, and agility
- Obtain access to new technology
- Reduce costs
  - Use lower cost, more flexible workforce
  - Employ more efficient business practices, thereby requiring fewer staff
  - Achieve more efficient utilization of facilities/equipment
  - Avoid capital investment in infrastructure
  - Reduce inventories
- Generate revenue through asset sales

## Private Sector Experience: Information Technology -- Expectations vs. Benefits

Information technology represents the largest outsourcing market in the United States, accounting by some measures for one half to two thirds of all outsourcing dollars. Many companies do not have ready access to a specialized IT workforce, and seek to avoid the technological risks and extensive capital outlays associated with maintaining an effective IT operation. These unique features of the information technology environment make the IT function an exceptionally attractive candidate for outsourcing.

The Gartner Group, which provides advisory services on IT issues, conducted a survey of 180 clients in October 1994 on outsourcing expectations and benefits.<sup>18</sup> About 60 percent of the surveyed firms already were outsourcing one or more IT functions; 75 percent of the respondents planned to outsource additional functions or to consider outsourcing for the first time within the next 18 months.

According to the survey, improved IT capabilities was the primary motivation of about 30 percent of outsourcing firms. This general category includes three sub-elements: improved IT responsiveness (the primary motivation for 14 percent of the firms); faster transition to client/server environment (9 percent); and improved business capabilities (7 percent).

Cost savings were the primary motivation of 27 percent of the outsourcing firms -- the single most frequently cited reason for outsourcing -- followed by the desire to improve the strategic use of staff (i.e., focus on core business). Ten percent of the firms surveyed cited access to skilled personnel as their primary reason for outsourcing IT functions.

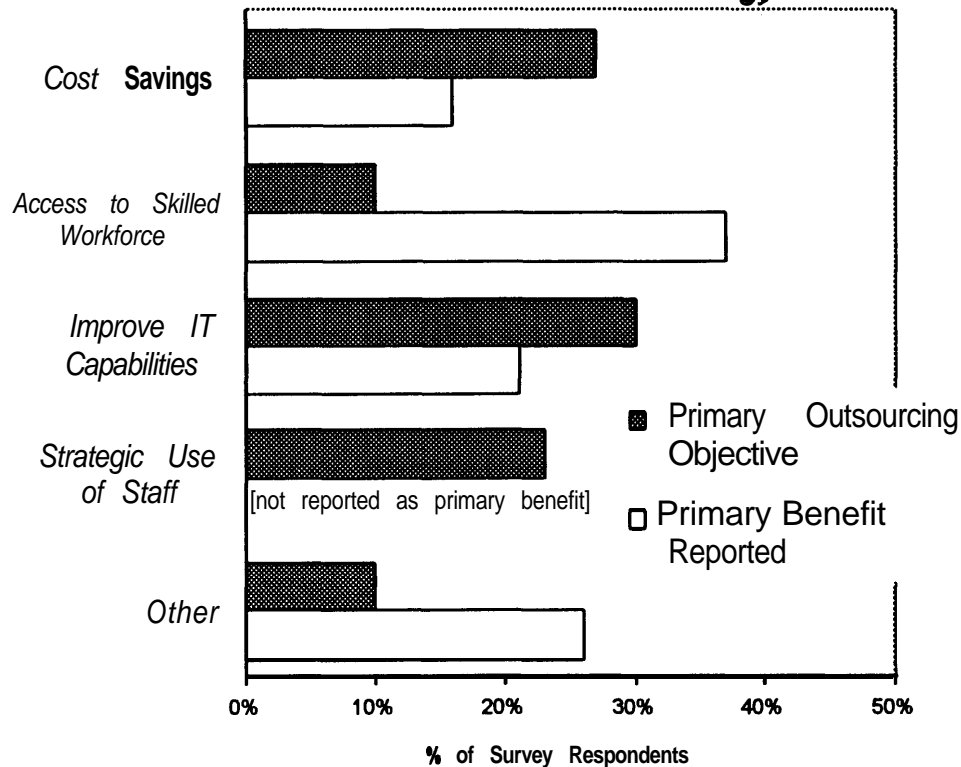
Interestingly, the survey indicates that the actual benefits realized through outsourcing diverge somewhat from initial expectations. For example, 21 percent of outsourcing companies identified improved IT performance as the primary benefit of outsourcing, while only 16 percent cited cost savings. (This result does not indicate that no savings were achieved, but that these cost reductions were considered less important than other benefits.) In contrast, 37 percent of responding firms indicated that the greatest advantage of outsourcing proved to be their improved access to skilled IT professionals.

The survey also indicated that 38 percent of the firms considered their outsourcing experience successful, compared to 29 percent who indicated "mixed" outcomes. None of the firms surveyed indicated that IT outsourcing had been an outright failure.

This survey validates a general trend in the outsourcing market. Firms increasingly view outsourcing as a strategic tool to enhance the capabilities and effectiveness of the entire enterprise, not primarily as a means for reducing function costs.

# Private Sector Experience: Info Tech -- Expectations vs. Benefits

Survey of 108 Firms That Have Outsourced At  
Least One Information Technology Function



Source: Gartner Group, April 1995.

- ❑ *Cost savings & improved capabilities are leading IT outsourcing objectives*
- ❑ *However, primary benefit is access to skilled workforce*
- ❑ *38% of firms indicate IT outsourcing a “success”; no “failures” reported (rest mixed or too early to tell)*
- ❑ *75% of respondents actively considering additional IT outsourcing*

### Private Sector Experience: Commercial Airline Maintenance

U.S. commercial airlines outsource about 15 to 20 percent of their total maintenance workload, which includes line (“O-level”), intermediate, and depot-level maintenance.<sup>19</sup> This percentage has grown steadily in recent years -- a trend that is likely to continue.

Major U.S. airlines can be divided into two groups: younger airlines that have emerged after the late 1970s (the era of airline deregulation), which outsource virtually all of their depot-level maintenance, and the older, established airlines that maintain most of this workload in-house. All major carriers maintain an internal line (“O-level”) maintenance capability.

Outsourcing airlines include Alaska, America West, and Southwest. These airlines contract out virtually all depot-level workloads. Executives of emerging airlines claim that outside vendors provide lower cost and improved management flexibility, while eliminating the need to establish expensive maintenance facilities. One airline claims that it achieved an 18 percent reduction in fully-loaded maintenance man-hour costs by contracting out depot workload. Moreover, airlines that outsource a high percentage of their maintenance workload tend to have higher reliability rates than the industry average.

In contrast, the large, established airlines (American, Delta, Northwest, TWA, United, USAir) perform most of their depot-level engine and airframe overhauls in their organic facilities. However, these airlines increasingly outsource maintenance for complex avionics and engine components, primarily to avoid the costs associated with purchasing and operating the specialized equipment and spare parts required for these tasks. Outsourcing is also attractive for relatively unskilled tasks -- such as the repair of seat covers -- which can be performed more cheaply by contractors.

The established airlines face significant constraints on their ability to transfer additional maintenance workload to outside vendors. These airlines have created an extensive maintenance infrastructure and have strong economic incentives to fully utilize these facilities. Union agreements often prohibit outsourcing of work that can be performed by company employees. In many airlines, the corporate culture also plays a role in discouraging full-scale outsourcing.

Most outsourcing airlines use long term (five to ten year), fixed-price outsourcing contracts. Rates are negotiated annually, and the airline can cancel the contract for poor performance. “Power-by-the-hour” (PBTH) arrangements are growing in popularity. Under this approach, the airline contracts for performance, rather than a specific repair, and the vendor assumes material management responsibility for the item. PBTH provides airlines with greater maintenance cost stability and predictability, reduces inventories, and gives vendors strong incentives to improve reliability. PBTH arrangements are most prominent in engines, auxiliary power units, landing gear, and tires.

Airlines also outsource many non-maintenance functions, including food service, pilot training, and data center operations.

# Private Sector Experience: Commercial Airline Maintenance

- Emerging airlines (Southwest, America West, Alaska) outsource virtually all depot maintenance
  - Recent case: outsourcing cut loaded man-hour rate by 18%
- Large established airlines perform most airframe & engine overhaul in-house, but outsource most complex components
  - Constraints: infrastructure, labor agreements, culture
- Outsourcing airlines tend to have somewhat lower maintenance costs -- & comparable or better reliability
- Increasing use of fixed price maintenance contracts and “power-by-the-hour” (PBTH) arrangements
  - PBTH: engines, auxiliary power units, landing gear, tires

### **Private Sector Experience: New Service Industries**

An extensive industry of service providers has emerged to meet the requirements of outsourcing firms for high quality, responsive support across a range of business functions. Most service providers in the outsourcing industry generally fall into one of three general business areas: information technology, business logistics, and business services.

As noted above, information technology represents the single largest business area, accounting for up to one half to two thirds of the value of all outsourcing contracts. Primary IT functions include data center operations, network support, systems integration, software maintenance, application development, and telecommunications. Commercial vendors of IT services generated almost \$12 billion in 1994 revenues, mostly concentrated among 15 major vendors.<sup>20</sup>

Business logistics -- including inventory management, warehousing, and transportation services -- may be the second most important market in the outsourcing industry. In recent years, service providers in this area have developed the worldwide intermodal transportation networks and transportation management systems that dramatically reduce delivery times and reduce distribution. Several major corporations have recently outsourced the entire logistics function to these service providers -- and competitive pressures are likely to drive more firms in this direction in the near future.

Business services are the third functional area in which outsourcing is making a prominent impact. Business services range from general administrative and "back room" support to facility management and benefits administration. While firms have for many years outsourced portions of such support functions, this outsourcing was usually performed at the task level by outside consultants or small, specialized firms. Increasingly, however, pressures to reduce administrative costs and increase flexibility are encouraging firms to look to providers of a broad range of services not only to perform specific tasks, but to manage and integrate these activities.

In addition to these three primary areas, vendors provide a diverse and expanding range of support services. In the view of the Task Force, the private sector has the capabilities and expertise to meet the requirements of DoD for most non-combat support functions.

# Private Sector Experience: New Service Industries

□ The outsourcing trend has spawned a number of service industries across a range of business functions, including:

- Accounting/Finance
- Internal Audit
- Data Center Operations
- Software Maintenance
- Network Support
- Applications Development
- Aircraft/Ship Maintenance
- Inventory Management
- Telecommunications
- Transportation Services
- Facility Management
- Benefits Administration

*Such service industries will generate an estimated \$100 billion in total 1996 outsourcing sales.*

### Private Sector Experience: Outsourcing Timelines

This slide identifies the key phases of the outsourcing process, **as** well as the average amount of time required for each phase. The graphic is based upon the results of a 1994 Outsourcing Institute survey of 30 outsourcing firms.<sup>21</sup>

The outsourcing process is broken down into seven discrete steps, which themselves may be grouped into three separate phases: the presolicitation phase, the solicitation phase, and the implementation phase. On average, firms required 14.6 months to complete the outsourcing process, with the quickest outsourcing action taking 6 months and the most prolonged requiring 24 months.

The presolicitation phase includes the assembly of the internal project team, the identification and evaluation of candidate functions for outsourcing, and the development of the request for proposal (RFP). Together, these steps require about 4 1/2 months or about 30 percent of the total process time. According to the survey, the Chief Financial Officer typically spearheads the outsourcing team and exerts top-down leadership. The outsourcing decisions are generally made by a small group of senior executives. Outsourcing firms regard the development of an effective RFP as critical to the success of the outsourcing action; 65 percent employ output-oriented performance measurements in the RFP as a means of evaluating and rewarding contractor performance.

In the solicitation phase, the outsourcing firm reviews and evaluates vendor proposals, selects a service provider based on the proposals, and negotiates the final contract. These steps require on average about 5 months, or slightly more than one third of the total process time. When deciding which vendors should receive the RFP, outsourcing firms consider reputation, experience, and existing relationships -- price is not a key factor. In the proposal evaluation, the firms tended to adopt a balanced, "best-value" approach, one that considered reputation, proposed contract terms, and proposed technical approach in addition to price.

The third phase of the outsourcing process is the implementation phase, which includes the development of a detailed implementation plan and the actual transition of the support function to the vendor. This phase requires on average slightly more than five months.

This timeline is relatively short compared to the lengthy DoD procurement process, where contract awards often require 24 to 30 months or more. Nevertheless, there is considerable pressure on outsourcing firms to compress this process.



# Private Sector Experience: Outsourcing Timelines

	Avg. Number of Months	
<i>Assemble Project Team</i>	<b>1.2</b>	Presolicitation Phase: 4.4 months
<i>Identify Candidate Functions</i>	<b>1.6</b>	
<i>Prepare RFP</i>	<b>1.6</b>	
<i>Review Vendor Proposals</i>	<b>2.6</b>	Solicitation Phase: 5.0 months
<i>Finalize Vendor Contracts</i>	<b>2.4</b>	
<i>Develop Detailed Implementation Plan</i>	<b>2.6</b>	Implementation Phase: 5.2 months
<i>Implementation</i>	<b>2.6</b>	
<b>TOTAL</b>	<b>14.6</b>	

*Outsourcing timelines in the private sector average about 15 months -- less than half the DoD average.*

Source: Outsourcing Institute, 1995; based on survey responses of 30 outsourcing firms.

## Private Sector Experience: Outsourcing Lessons -- Management

The Task Force has identified several key factors that are critical to the success of outsourcing initiatives in the private sector, based on extensive discussions with representatives of vendors and outsourcing firms. These “lessons learned,” which are summarized in this and the following two slides, may also have broad application to the DoD environment. This slide focuses on management issues.

**Senior executive leadership:** In the private sector, outsourcing actions usually are the result of a top-down decisionmaking process requiring the active involvement of the CEO, Chief Financial Officer, or other senior executive. Outsourcing decisions delegated to mid-level managers or others who may personally be affected by the outcome frequently focus on the obstacles to change, not the potential for dramatic improvement. Senior executive leadership must also be sustained through the development of the RFP, the selection of the vendor, and the implementation of the transition plan.

**Outsource broad processes:** There is a strong industry trend toward outsourcing broad business functions and processes, rather than narrow functions or tasks. This approach streamlines contract management and oversight, encourages greater synergy between outsourced activities, and provides senior executives with greater control and accountability over outsourced functions. The contracting out of specific tasks or small groups of tasks represents a suboptimal approach to outsourcing, as it results in higher oversight costs, reduced executive control, and poor coordination among support functions.

**View benefits from life cycle:** The full benefits of outsourcing may not accrue immediately after contracting out the function. Outsourcing yields the most positive results when the vendor reengineers the function through the application of innovative technologies and business practices. This reengineering process often requires the vendor to devote considerable time to analyzing the “as is” process and developing new, more efficient business practices. Moreover, disagreements over work scope or vendor strategies are common during the initial stages of the contract. These differences usually are resolved satisfactorily over time. For these reasons, the outsourcing project should not be evaluated in the first year after the contract award, but at the conclusion of the project from a life cycle perspective.

**Small, highly trained oversight cadre:** Successful outsourcing firms tend to perform contract management and oversight with a small group of functional experts and contract administrators who interact with vendor personnel on a day-to-day basis. This oversight cadre usually is co-located with the vendor at the work site. In fact, the potential savings and flexibility of outsourcing can be lost if the client firm imposes a large, distant bureaucratic oversight structure on the service provider.

**Partnership: A key factor in successful outsourcing ventures is establishing a partnership between the outsourcer and the vendor.** While the oversight team must hold the vendor to high standards, the outsourcing firm should cultivate a collaborative rather than adversarial relationship that emphasizes identifying and resolving potential problems before they impact service delivery.

# Private Sector Experience: Outsourcing Lessons -- Management

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- ❑ Strong, sustained senior executive leadership is key to successful implementation of outsourcing decisions
- ❑ Benefits are greatest when firms outsource broad business processes, not piecemeal functions or organizations
- ❑ Firms often encounter initial “bumps in the road,” but usually resolve start-up issues with vendors to achieve long-term benefits
- ❑ Firms with a successful history of outsourcing usually perform oversight with a **small** team of well-trained functional experts & contract management personnel
- ❑ **Outsourcer must establish a true partnership with vendor and approach problem solving as a team.**

## Private Sector Experience: Outsourcing Lessons -- Contracting

**Performance specifications, best-value RFPs:** Outsourcing yields the greatest benefits when the service provider applies superior technology and business practices to reengineer the support function. The RFP must encourage bidders to adopt new ways of doing business to reduce costs and improve service delivery, and not “freeze” the outsourcing firm in an obsolete technology or business practice. Accordingly, RFPs should utilize performance standards, not detailed “how to” specifications characteristic of most DoD solicitations. Functional experts should be involved in developing the RFP.

Leading U.S. corporations view service contracts from a “best value” perspective. Successful outsourcing firms place greater value in vendor evaluations on past performance, vendor relationships, and proposed approach than on labor rates or even proposed contract costs. To the extent possible, RFPs should require bidders to propose reimbursement schemes based on measurable outputs (e.g., number of payroll checks accurately generated and delivered) rather than time and materials.

**Contract scope:** Both industry surveys and practical experience of industry executives suggest that the primary source of problems in outsourcing is disagreement between the outsourcing firm and service provider over the scope of the statement of work. To avoid such misunderstandings, the client and vendor must thoroughly discuss the statement of work and come to a true “meeting of the minds” regarding key contract provisions. The service provider should also have the opportunity to comment upon and influence the final statement of work, as vendors are likely to have the most experience in shaping successful outsourcing contracts in their area of specialization. Since outsourcing contracts can be extremely complicated, firms with little outsourcing experience often retain consultants or hire staff specialists with expertise in this area.

**Performance incentives:** Successful outsourcing firms often seek to align the interests of client and vendor through the use of performance incentives which reward the service provider for reducing costs and/or improving service quality and responsiveness.

**Long-term contracts:** As noted above, outsourcing benefits the client firm over the long-term, primarily through the reengineering of business processes. Accordingly, contracts limited to a year or two often provide the service provider with insufficient opportunity to deploy innovative technologies or implement improved business practices. As a result, the standard length of large service contracts in the private sector is five to ten years, and rarely is the period of performance less than three years. To protect outsourcing firms, such contracts typically include broad cancellation clauses that allow the firm considerable latitude in terminating the contract for non-performance.

**Market forces:** Outsourcing generates benefits by applying the discipline and competitive pressures of the marketplace to support functions traditionally performed by in-house monopolies. Outsourcing firms generally strive to maintain a competitive environment through periodic recompetitions, by maintaining more than one supplier for a given support function, and/or by utilizing performance incentives that encourage cost reductions and service improvements.

# Private Sector Experience: Outsourcing Lessons -- Contracting

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- ❑ Most commercial outsourcing RFPs employ performance specifications, best value contracting approach
- ❑ Key element of successful contract: clear scope that is fully understood by both parties and reflects vendor input
  - Most problems caused by disagreements over scope
  - However, vendor needs flexibility to reengineer processes and deploy new technologies
- ❑ Outsourcing firms use output-oriented performance incentives to align the interests of client and vendor
- ❑ Outsourcing contracts tend to be for five to ten years, but include cancellation clauses

## Private Sector Experience: Outsourcing Lessons -- Personnel

Personnel issues are a primary constraint on the expansion of outsourcing in the private sector. Labor unions view corporate outsourcing initiatives with great concern; outsourcing has become a key issue in negotiations on collective bargaining agreements. While outsourcing is likely to remain a controversial issue with many workers, leading corporations are taking proactive steps to address employee concerns and to mitigate the impact of outsourcing decisions on affected workers.

**Continuous communications:** There is strong agreement in U.S. industry on the need for sustained and effective communication throughout the outsourcing process. Successful firms keep the workforce well-informed regarding outsourcing initiatives under consideration, the rationale for such measures, and the transitional assistance that the company plans to provide affected employees. Unions are engaged early in the process and are given the opportunity to have an input into the structure of the transition package.

**Reemployment:** When firms outsource major support functions, the vendor must employ large numbers of trained and capable workers in a short period. Usually, the only practical option open to the vendor is to hire many of the displaced employees of the outsourcing firm. On many occasions, the outsourcing firms may require that service provider grant the "right of first refusal" to displaced workers as a condition of the service contract. However, some workers will not be re-hired, as vendors usually perform the support function with significantly less manpower than previously utilized. Since vendors base compensation on local market conditions, re-hired workers sometimes experience some reduction in pay and benefits.

**Transitional assistance:** Most major U.S. corporations with extensive experience in outsourcing provide transitional assistance to affected employees, including the opportunity to seek employment elsewhere in the company; severance payments based on length of service; early retirement to qualified workers; retraining; and outplacement services. The social contract between companies and their workers is shifting from a commitment to lifetime employment security to a commitment to lifetime employment opportunity.

**New opportunities:** Senior industry executives estimate that about one third of the re-hired employees typically flourish in the new environment. These workers quickly move up in the vendor organization to take on broader responsibilities. Another third of this workforce usually has difficulty adjusting to the new work environment and eventually leaves the vendor for other employment opportunities.

# Private Sector Experience: Outsourcing Lessons -- Personnel

- ❑ Sustained communication with workforce and early involvement of unions pay dividends later on
- ❑ Vendor usually reemploys workforce that performed function for outsourcing firm
  - Often half or more of affected employees are retained
- ❑ Leading firms provide transitional assistance to affected workers -- retraining, early outs, outplacement help, etc.
- g Outsourcing may create new opportunities
  - Best workers often flourish in new environment
  - Broader opportunities and growth potential

## **Briefing Outline: Public Sector Experience**

This section provides an overview of public sector experience with outsourcing.



# Briefing Outline

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- ❑ Background
- ❑ The Challenge
- ❑ Private Sector Experience
- ❑ Public Sector Experience
- ❑ Primary Impediments
- ❑ Proposed Strategy
- ❑ Recommendations



### **Public Sector Experience: Overview**

This slide summarizes the major points addressed in this section. In summary, this section argues that the public sector already has extensive, highly successful experience with outsourcing. Despite its flawed approach to outsourcing, DoD has obtained significant cost savings and other benefits from its somewhat limited efforts to transfer support functions to the private sector. However, the Department has outsourced only a small portion of its commercial activity workload.

# Public Sector Experience: Overview

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- ❑ Many state/local governments are using competition & outsourcing to reduce budgets & improve services
- ❑ Research indicates that outsourcing generates significant savings when used in the public sector
- ❑ DoD has outsourced only 25% of the 850,000 positions involved in commercial-type activities
- ❑ DLA is reducing costs and improving responsiveness through innovative approaches to outsourcing
- ❑ Outsourcing responsibility for integrated facility management of DoD installations results in lower cost, higher quality base support services

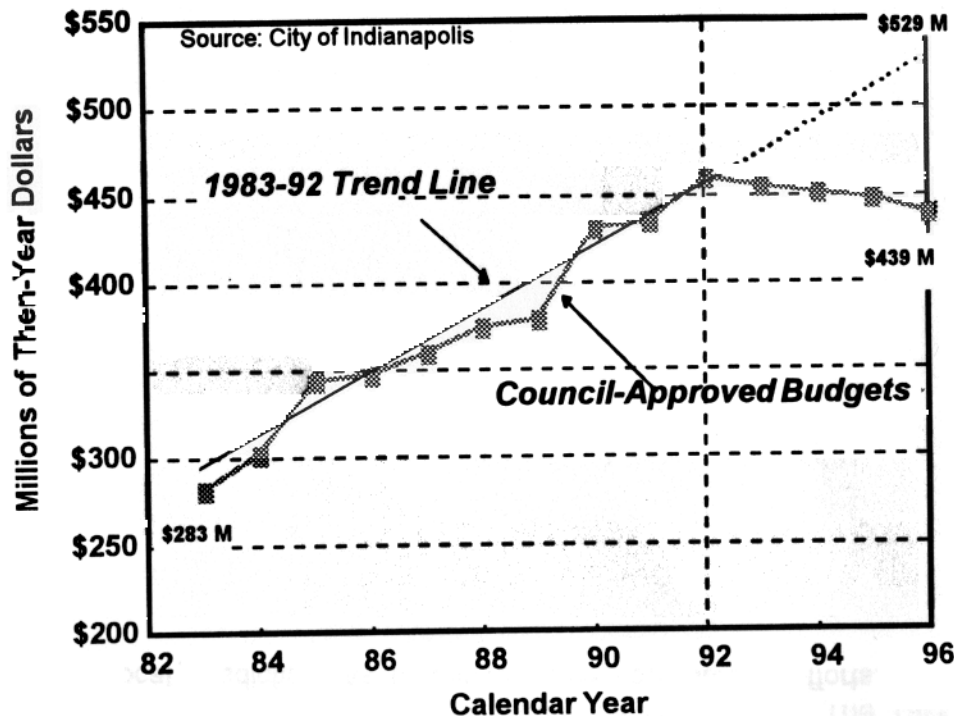
### **Public Sector Experience: City of Indianapolis**

Many state and local governments have adopted a strategy of public/private competition and outsourcing to reduce costs and improve service delivery. Success stories include Kansas City, Minneapolis, Newark, Philadelphia, and Phoenix.\* In this slide, we focus on the experience of Indianapolis, which implemented an aggressive program of public/private competition in 1992. (Indianapolis is used for this case study review because the Task Force had the opportunity to discuss the Indianapolis outsourcing initiative with the city official who has primary responsibility for implementing public/private competitions.)

Since 1992, the City of Indianapolis has conducted 60 public/private competitions involving a broad range of municipal functions, including: airport operations/maintenance; information technology; facility maintenance/management; fleet maintenance/management; parking ticket writing; road maintenance; solid waste collection; and wastewater treatment. To date, private vendors have won about half of the competitions, but only account for about 85 percent of total contract value.

The results are impressive. During the 1983-92 period, City budgets increased steadily by about \$20 million annually. However, the trend has shifted dramatically since the implementation of the City's aggressive public/private competition strategy. City budgets have actually declined for four consecutive years. The 1996 municipal budget is \$90 million less than what it would have been had the 1983-92 trendline continued. City officials also indicate that these cost reductions have been accompanied by across-the-board improvements in service delivery.

# Public Sector Experience: City of Indianapolis



**Of the 60 functions competed since 1992, private firms won about 1/2 the competitions, but 85% of their total value. Competed functions include:**

- Airport operations/maintenance
- Information technology
- Facilities maintenance/mgmt
- Fleet maintenance/mgmt
- Parking ticket writing
- Road maintenance
- Solid waste collection
- Wastewater treatment

*After introduction of competition & outsourcing strategy in 1992, city budgets fell dramatically -- with marked improvements in services*

**Public Sector Experience: City of Indianapolis (continued...)**

This slide provides additional detail regarding cost savings and other benefits obtained by the City of Indianapolis from its strategy of competition and outsourcing. Public/private competition has already generated \$80 million in actual savings; an additional \$150 million are anticipated from existing contracts. In just four years, the City has succeeded in trimming the rolls of non-public safety personnel by 40 percent -- a remarkable achievement realized entirely through attrition. Such savings have enabled Indianapolis to invest approximately \$500 million into new infrastructure without a tax increase.

In other words, the City of Indianapolis -- like many other state and local governments -- has used outsourcing as an effective tool to reduce operating costs and generate new resources for investment. The Task Force believes that DoD should look to Indianapolis and other innovative local jurisdictions as models for its own outsourcing efforts.

# Public Sector Experience: City of Indianapolis (continued...)

## **1992-95 Benefits:**

- ❑ Cost savings
  - \$80 million in “banked” savings
  - \$150 million in contractually committed savings
  - 4 years of declining budgets after 10 consecutive increases
- ❑ Across-the-board service improvements
- ❑ 40% reduction in non-public safety personnel
- ❑ \$500 million in new infrastructure with no tax increase
- d Significant increase in minority contracting

*The use of activity-based costing to assess government costs has been key to the success of the Indianapolis strategy*

Source: City of Indianapolis

### Public Sector Experience: DoD Commercial Activities

The Services and defense agencies are required periodically to report information on contractor and in-house personnel who perform services that are generally available in the private sector. This information is consolidated in the DoD Commercial Activities Inventory Data Base, which is maintained by the Office of the Secretary of Defense.

This database indicates that, despite strong evidence that outsourcing generates significant cost savings, DoD continues to perform most commercial-type activities with in-house personnel.

According to the database, DoD devoted 850,000 full-time equivalents (FTEs) to commercial-type activities in 1994. These FTEs were involved in over 150 different separate functions in the following categories:

- social services
- base maintenance
- data processing
- health services
- RDT&E support
- manufacturing/fabrication
- intermediate maintenance
- installation services
- maintenance of real property
- depot maintenance
- education & training
- Other non-manufacturing

The database indicates that 210,000 FTEs – only one quarter of the total population involved in DoD commercial-type activities -- were performed by outside contractors in 1994. The remaining 640,000 FTEs are in-house military and civilian personnel. The table on page 11 provides a breakout of these FTEs by functional category. Interestingly, almost half of the in-house commercial activity FTEs are military personnel. OSD and the Military Services are currently reviewing the in-house commercial activity population to identify additional FTEs for possible outsourcing.

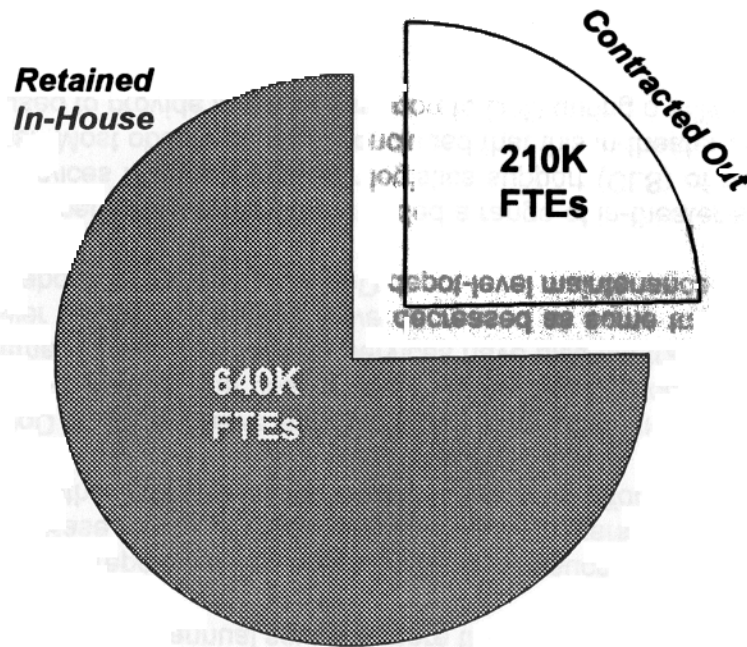
There are indications that the number of DoD personnel involved in commercial-type activities may greatly exceed the reported figures. While there are over 800,000 civilians employed by DoD only 337,000 show up in the database. Presumably, most of these civilian FTEs are performing work that is commercial in nature. Moreover, the Services use divergent criteria to identify commercial activity FTEs, apparently resulting in significant undercounting, particularly of military personnel. For example, DoD sources indicate that there are about 67,000 DoD personnel involved in individual training -- not 17,000 as indicated in the database. The Task Force encourages DoD to review the existing reporting standards and modify them as necessary to identify all DoD personnel engaged in commercial-type activities.

In the view of the Task Force, most support functions involving commercial-type activities should be performed by outside vendors, including those activities currently being performed by military personnel.



# Public Sector Experience: DoD Commercial Activities

## DoD Commercial Activities Universe



Source: DoD Commercial Activities Database.

- ❑ Only 25% of DoD commercial activity full time equivalents (FTEs) are currently outsourced
- ❑ DoD targeting an additional 10% of in-house FTEs for possible outsourcing
- ❑ Many in-house FTEs are military personnel in non-combat support roles with significant outsourcing potential
- ❑ Because of reporting problems, the number of in-house FTEs actually involved in commercial-type activities may be significantly greater than 640K

### Public Sector Experience: DoD Success Stories

Most DoD organizations have not moved aggressively to transfer support functions to the private sector. Nevertheless, the Department can point to several successful examples of outsourcing.

For example, despite the difficulties associated with the A-76 process (which are discussed on pages 41 to 44), DoD executed over 2,000 A-76 public/private competitions during the 1978-94 period, about half of which were won by private contractors. These A-76 actions generated about \$1.5 billion in annual savings, more than 30 percent of total function costs.

The Air Force reportedly has also had significant success in outsourcing most installation support services at selected bases, including Vance Air Force Base (AFB) in Oklahoma and several overseas installations such as Incirlik AFB in Iceland. The Air Force is in the process of identifying other installations for similar outsourcing efforts.

Other DoD functions have also benefited from outsourcing. As noted in the following slide, DLA has employed innovative outsourcing strategies -- such as the use of direct vendor delivery contracts for pharmaceuticals -- to reduce costs and delivery times in the materiel management area. The Military Services have also contracted out a portion of their institutional training programs. Expenditures for military manpower devoted to training have decreased as some training functions have been transferred to private vendors.<sup>23</sup> Finally, contractors perform about 30 percent of all DoD depot-level maintenance and overhaul, generally with positive results.

Contractor personnel have also provided a range of in-theater support services during every military deployment since the Vietnam conflict.<sup>24</sup> These services include contractor logistics support (CLS) of new systems, as well as a range of logistic, administrative, and other support functions. Most observers have concluded that this in-theater contractor support is both responsive and effective. To our knowledge, no firm has refused to provide in-theater support to DoD during a military contingency.

# Public Sector Experience: DoD Success Stories

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- ❑ Despite its shortcomings, A-76 process has generated significant savings for DoD
- ❑ Air Force base support: outsourcing all functions
  - Selected CONUS bases (e.g., Vance)
  - Overseas bases (e.g., Incirlik)
- ❑ Other functions have had strong outsourcing successes
  - DLA materiel management
  - Individual skill training
  - Depot-level maintenance/overhaul
- ❑ In-theater outsourcing results: responsive, reliable support
  - Telecommunications in Vietnam conflict
  - Range of key support functions in Desert Shield/Desert Storm, Haiti, Bosnia

### **Public Sector Experience: DoD Materiel Management**

The Defense Logistics Agency (DLA) serves as the inventory manager for most DoD consumable items, as well as the distributor/warehouse of all DoD wholesale inventories. The total value of the DIA inventory exceeds \$10 billion.

DLA is using outsourcing as a powerful tool in its strategy to reinvent itself as a material broker that efficiently brings together outside vendors and DoD customers, but no longer handles, warehouses, or distributes many consumable items.

Direct vendor delivery (DVD) is a key element of this strategy. Under this approach, the vendor delivers items purchased under DLA contract directly to the consuming activity. By eliminating the DLA warehouse from the distribution chain, DVD improves delivery response times, reduces inventory, and allows DoD to divest costly infrastructure. DVD items accounted for \$1.4 billion in FY95 sales, or about 32 percent of the total. DLA plans to extend DVD coverage to 50 percent of total sales by FY97.

Prime vendor contracts represent a further innovation in streamlining DLA's involvement in the distribution chain. After DLA completes a prime vendor contract with a private firm, DoD activities may place orders for consumable items directly with the vendor, which then delivers the item directly to the consuming activity. DLA has concluded prime vendor contracts with a range of pharmaceutical firms, with spectacular results. Prices for pharmaceuticals have fallen 25 to 35 percent, delivery times have declined dramatically, and now most items are delivered within 24 hours of order placement.

DLA's experience with DVD and prime vendor contracts demonstrates that outsourcing generates the greatest benefits when it is used as a tool to reengineer established business practices. The Task Force encourages DLA to extend these concepts to other appropriate areas to reduce inventories and shorten delivery times.

# Public Sector Experience: DoD Materiel Management

- Direct vendor delivery (DVD)
  - Vendor delivers against DLA contract directly to customer
  - Improves response, reduces inventory & infrastructure
  - DVD is \$1.4B or 32% of FY95 sales; FY97 goal is 50%
  
- Prime vendor contracts
  - Customer deals directly with vendor
  - Medical is key example
    - DLA medical inventory reduced 61% since 1991
    - 25-35% price reductions & 24 hour response times
  - \$560M in FY95 sales; goal is \$1.2B by FY99

*The Defense Logistics Agency (DLA) is cutting costs, boosting service by moving from **material wholesaler to material broker** through the use of innovative outsourcing strategies*

### Public Sector Experience: A-76 Savings

Most outsourcing activity in DoD has been governed by OMB Circular A-76, which requires that Federal agencies conduct public/private competitions prior to outsourcing support functions. The A-76 process will be discussed in greater detail in later sections of this report. This slide summarizes the results of A-76 public/private competitions during the 1978-94 period. The Center for Naval Analyses (CNA) developed this table based on its analysis of the DoD Commercial Activities Inventory Data Base.<sup>25</sup>

The Services account for the vast majority of the A-76 competitions conducted during the 1978-94 period. Defense agencies performed less than 100 A-76 actions during the period, compared to the Service total of 2,138. Documented savings total about \$1.5 billion annually, an average of 31 percent across all Services. The Air Force achieved average savings of 36 percent, the highest of the four Services. The Army, though showing the lowest returns, still recorded a substantial 27 percent savings on competed functions.

These savings primarily reflect reductions in the amount of manpower required to perform the competed service. Staff reductions are achieved by fostering greater flexibility in work assignments, greater use of temporary workers and part-timers, and the sharing of underutilized workers with other organizations. Some of the savings realized by outside vendors result from somewhat lower hourly labor rates.

The table summarizes the results of all Service A-76 actions, including competitions won by the in-house entity. Outside vendors won 52 percent of all A-76 public/private competitions, accounting for 64 percent of the total workload. Moreover, contractors generated 78 percent (about \$1.2 billion) of the total savings.

It should be noted that these A-76 actions generally involved relatively narrow, unskilled functions involving on average only about 35 government employees. The Task Force believes that DoD could significantly improve its saving performance by outsourcing larger, more complex functions, thereby providing vendors with maximum opportunity to reduce costs and improve service quality.

# Public Sector Experience: A-76 Process Savings

Savings from A-76 Competitions, 1978-94

<b>Service</b>	<b>Competitions Completed</b>	<b>Total Annual Savings (FY96 \$M)</b>	<b>Percent Savings</b>
<b>Army</b>	510	470	27%
<b>Air Force</b>	733	560	36%
<b>Marine Corps</b>	39	23	34%
<b>Navy</b>	806	411	30%
<b>TOTAL</b>	<b>2,138</b>	<b>\$1,478</b>	<b>31%</b>

*Outside vendors won 52% of the A-76 competitions, but accounted for 78% of the total savings.*

Source: Center for Naval Analyses analysis of DoD Commercial Activities Inventory Data Base, 1996.

### **Public Sector Experience: Results of Navy A-76 Competitions**

This slide draws upon analysis performed by the Center for Naval Analysis (CNA) of the results of more than 800 Navy A-76 competitions conducted during the 1978-90 period.<sup>26</sup>

According to the CNA analysis, the Navy achieved average savings of nearly 30 percent for all public/private competitions. However, when the function was transferred to an outside vendor, savings totaled almost 40 percent. In contrast, reported savings totaled only about 20 percent when the work was retained in-house. Nevertheless, the government entity won 54 percent of the competitions.

The CNA analysis also indicates that A-76 actions tend to focus on relatively narrow functions involving few government employees. More than half involved fewer than 10 employees; less than 10 percent involved more than 55 workers.

The Navy data also indicates that outsourcing savings were highest when vendors took over functions traditionally performed by military personnel. In such cases, the Navy realized savings of nearly 50 percent of function costs. This savings rate reflects the relatively high cost of military personnel, including fringe benefits.

CNA also analyzed the impact of outsourcing on the quality and responsiveness of support functions, and found that transferring workload to outside vendors resulted in no significant quality problems.



# Public Sector Experience: Results of Navy A-76 Competitions

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*Selected results of Center for Naval Analysis  
analysis of 800+ A-76 competitions from 1987-90:*

- d Navy achieved average savings of 29% from A-76 actions
  - 40% when function was contracted out
  - 20% when function was retained in-house
- Most A-76 actions affected small, narrow functions: less than 10% involved more than 55 employees
- Outsourcing resulted in no significant quality problems
- Outsourcing military billets resulted in the greatest savings (about 50%)

### **Public Sector Experience: Integrated Facility Management**

The Task Force believes that DoD should move away from its traditional “stovepipe” approach to base support contracting, transferring responsibility to qualified service providers for integrated facility management of DoD installations.

Traditionally, base commanders award contracts to a range of vendors for relatively narrow support functions like solid waste removal and lawn care. In the opinion of the Task Force, this “stovepipe” approach tends to lead to relatively high contract management and oversight costs, poor coordination among outsourced functions, and little management visibility into and control over vendor services.

There is strong agreement among Task Force members that DoD should consolidate responsibility for all base support functions in a single contract for each installation. Under this approach, government contract administrators interact with a single contractor management team, resulting in significant reductions in oversight costs. Moreover, the vendor has much greater opportunity to exploit synergies and eliminate redundancies.

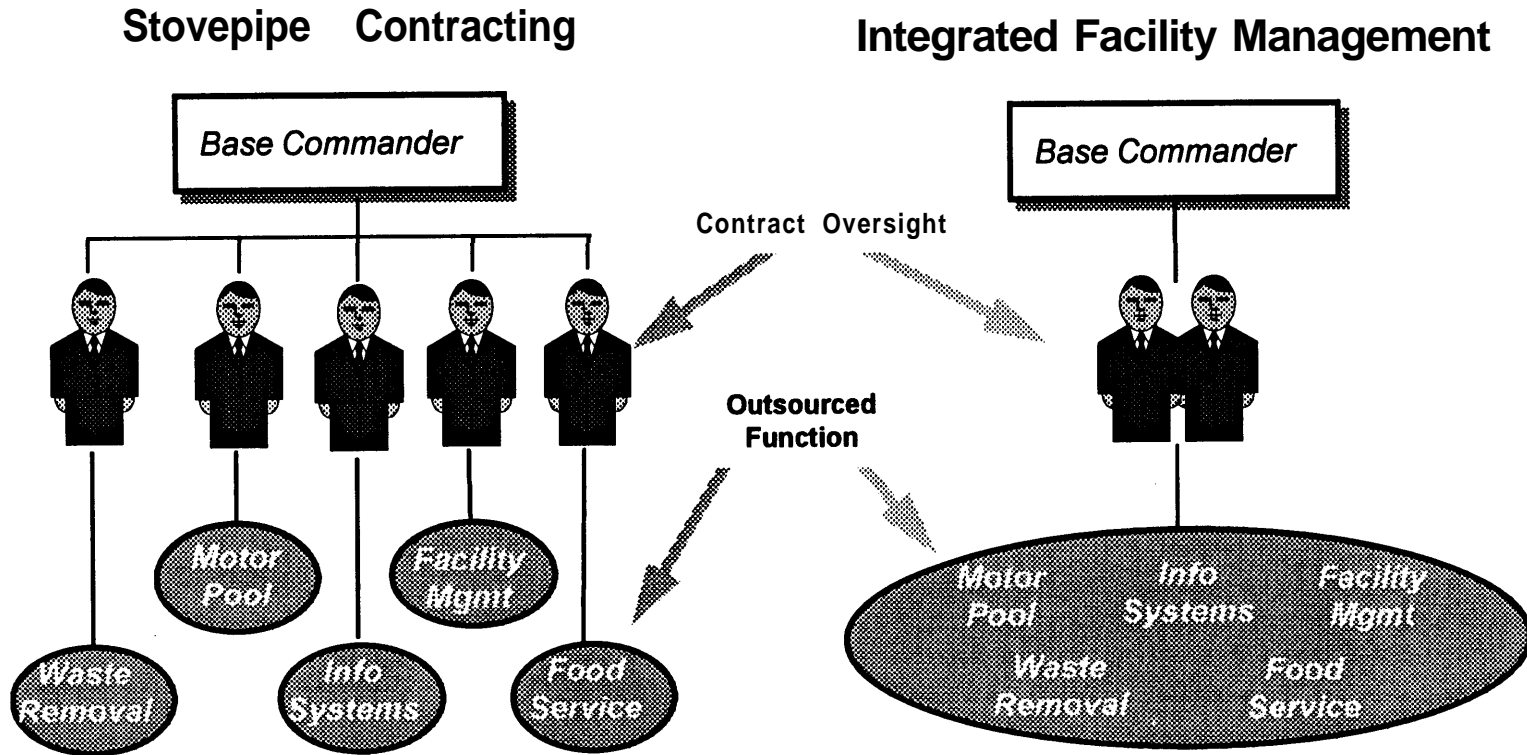
For example, the vendors in charge of the motor pool, facility maintenance, and waste removal under the traditional stovepipe contracting approach are likely to use separate facilities, equipment, and mechanics to maintain their vehicles. Under the integrated facility management model, however, the vendor has the opportunity and incentive to consolidate vehicle repair in a single facility, and utilize the same equipment and mechanics. Such synergies generate significant savings for both the contractor and DoD.

Moreover, integrated facility management provides DoD with the opportunity to sharply reduce the number of government personnel involved in installation support services. As noted in the table on page 11, base services account for approximately 135,000 DoD personnel. Placing a single contractor in charge of installation support services for each base would lead to the elimination of virtually all of these government positions.

Finally, integrated facility management raises the level at which contracts are managed within the government organization. By placing all outsourced support functions under a single vendor, senior base officials have more visibility into contractor operations and greater opportunity to take an active role in managing the support contract. This executive-level involvement results in more effective and responsive support.

It should be noted that this approach does not preclude the participation of small and/or disadvantaged businesses. DoD may wish to incorporate subcontracting requirements into base support contracts to ensure that prime vendors include such firms on their project teams.

# Public Sector Experience: Integrated Facility Management



*Outsourcing responsibility for integrated facility management streamlines program mgt/oversight, promotes synergy among functions, & results in more responsive, lower cost support.*

### **Public Sector Experience: Community Impact**

An aggressive DoD initiative to transfer most support functions to outside vendors is likely to have some impact on communities located near military installations. Outsourcing actions will lead to reductions in the number of government employees at these bases. Many of the affected workers will be absorbed by the vendor who is given the responsibility to perform the support function previously undertaken by DoD personnel. However, a significant percentage of the affected workers probably will not be re-hired by the service contractor.

DoD's experience with base closure under the BRAC process may be instructive. Some 43,000 government jobs were eliminated during the three BRAC rounds; approximately 17,000 new positions were created, mostly in the private sector. Many of the local economies affected by BRAC closures have rebounded well in recent years, often with a more diverse and stable economic base.

However, outsourcing probably will not have as strong an impact on local communities as BRAC. Transferring support functions to outside vendors will affect the size and composition of the base workforce, but in most cases will not result in the closure of the government installation. Outsourcing will boost private sector employment and may generate additional business tax revenues for local governments. In the view of the Task Force, most communities will benefit in the long run from a DoD shift toward greater reliance on the private sector for support services.

# Public Sector Experience: Community Impact

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- DoD base closure experience is illustrative, though BRAC dislocations are more severe and concentrated
  - New industries develop, providing good jobs
  - New economic base more diverse and stable
  - BRAC 88/91/93 -- 43,000 jobs lost, 17,000 created
  
- Examples of major outsourcing are few, but promising
  - Newark Air Force Base -- December 1995
    - Most of existing work force retained
    - Community reaction -- quite positive
  
- Redevelopment efforts underway in Pensacola, Charleston, Philadelphia, Indianapolis & other cities.

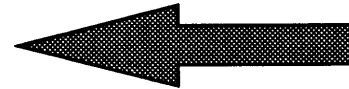
### **Briefing Outline: Impediments**

This section reviews the primary impediments to the implementation of an aggressive DoD outsourcing strategy

# Briefing Outline

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- ❑ Background
- ❑ The Challenge
- ❑ Private Sector Experience
- ❑ Public Sector Experience
- ❑ Primary Impediments
- ❑ Proposed Strategy
- ❑ Recommendations



### **Impediments: Overview**

As Deputy Secretary of John White noted recently, “The hardest things to change are institutions that have been successful and need to change anyway.”<sup>27</sup> DoD and the Services have been very successful in accomplishing their primary mission: to prepare for and fight military conflicts. In a way, this success makes it even more difficult for the institution to undertake the dramatic changes that are needed to ensure that United States continues as the world’s preeminent military power.

The primary impediments to the implementation of an aggressive DoD outsourcing strategy include statutory restrictions and Congressional micromanagement; the time-consuming and complicated nature of the DoD procurement process; the complexity and lack of equity in A-76 public/private competitions; the lack of adequate government cost data to support such competitions; DoD policies to preserve in-house capabilities to perform certain “core” maintenance tasks; and the resistance of the DoD culture to fundamental change. These impediments are discussed at greater length in the following slides.



# Impediments: Overview

- d Statutory restrictions
  - ❑ DoD procurement process
  - ❑ A-76 process
  - ❑ Poor government cost data
  - ❑ Concept of “core” support
  - ❑ DoD culture/lack of incentives

*“The hardest things to change are institutions that have been successful and need to change anyway.”*

— John White  
Deputy Secretary of Defense  
January 30, 1996

## Impediments: Statutory Restrictions -- Key Provisions

This slide summarizes several key legislative provisions that restrict DoD's ability to increase its reliance on the private sector for support functions. These provisions are described in greater detail below:

**10 USC 2461** requires that DoD conduct exhaustive analysis and reporting prior to outsourcing any function performed by more than 45 DoD employees. These requirements include advance notice to Congress that an outsourcing study is anticipated; a detailed cost comparison study; the development of a government "most efficient organization" (MEO) against which private sector cost projections must be compared; an economic impact study; and advance notice to Congress of the intent to outsource the function.

**10 USC 2464** requires the Secretary of Defense to identify core logistics functions which cannot be outsourced, and prohibits DoD from changing the classification of a core logistics function to non-core without prior notice to Congress.

**10 USC 2465** prohibits DoD from contracting out civilian guards and firefighters at most military bases.

**10 USC 2466** states that no more than 40 percent of the funds available for depot-level repair and maintenance may be outsourced to private contractors. This provision is the source of the existing "60/40 rule" governing the allocation of depot maintenance workload.

**10 USC 2469** requires that the Secretary of Defense conduct a public/private competition before outsourcing any depot-level maintenance workload with a value greater than \$3 million.

**Section 8020 of the FY96 DoD Appropriations Act** prohibits DoD from expending any funds to outsource DoD functions performed by more than 10 DoD civilian employees until a most efficient and cost effective analysis has been completed and the results certified to the Congressional Committees on Appropriations.

**Section 8043 of the FY96 Appropriations Act** prohibits DoD from expending any funds on A-76 cost comparison studies that exceed 24 months for one function or for 48 months for more than one function.

**Section 317 of the FY87 DoD Authorization Act** prohibits DoD from outsourcing any function performed at McAlester or Crane Army Ammunition Plants (AAPs).

In addition to these provisions, **10 USC 2468** provided base commanders with sole authority to commission A-76 cost comparison studies at their installations. This statute, which expired on September 30, 1995, contributed significantly to the dramatic decline in the number of A-76 studies completed in recent years.

# Impediments: Statutory Restrictions -- Key Provisions

<i>Citation</i>	<i>Summary</i>	<i>Citation</i>	<i>Summary</i>
10 USC 2461	Mandates extensive reporting to Congress, including cost comparison study, prior to outsourcing	10 USC 2469	Depot maintenance work >\$3 M may not be outsourced without public/private cost comparison
10 USC 2464	Logistics requirements defined as "core" cannot be outsourced	Sec 8020, FY96 Appro Act	Requires MEO analysis of all functions of >10 DoD civilian employees before outsourcing
10 USC 2465	Prohibits outsourcing of civilian firefighting or security guard functions at military bases	Sec 8043, FY96 Appro Act	No funds for A-76 studies which exceed 24 months for 1 function or 48 months for >1 function
10 USC 2466	Limits outsourcing of depot maintenance to 40% of total	Sec 317, FY87 Auth Act	Prohibits contracting out of any function at McAlester or Crane Army Ammunition Plants

### **Impediments: Statutory Restrictions -- Key Impacts**

The statutes identified on the previous slide increase the involvement of Congress in outsourcing decisions and expand opportunities for Congressional micromanagement; require extensive Congressional notifications and reporting, including the preparation of exhaustive cost analysis studies; impose arbitrary limits on the share of depot-level maintenance workload that may be outsourced to private contractors; and establish arbitrary exemptions from outsourcing of selected functions such as fire safety and physical security. Moreover, the history of Congressional reaction to past DoD outsourcing initiatives has a “chilling effect” on DoD activities that are considering contracting out other workloads.

Taken together, the current legal environment encourages the politicization of the outsourcing decision process, and thereby complicates, delays, and discourages DoD efforts to increase its reliance on private vendors for support services.

# Impediments: Statutory Restrictions -- Key Impacts

- ❑ Congressional micromanagement of outsourcing decision making and execution process
- ❑ Burdensome reporting requirements imposed on gov't activities conducting public/private cost comparisons
- ❑ Arbitrary limit on the proportion of depot maintenance work that may be performed by contractors (40% of total)
- ❑ Arbitrary exemptions from outsourcing of some prime candidate functions (e.g., fire safety, physical security)
- ❑ Fear of more restrictive Congressional measures compels some DoD activities to move slowly on outsourcing

*Result: a legal and regulatory environment that complicates, delays, and discourages outsourcing*

### **Impediments: DoD Procurement Process**

In recent years, DoD has taken some important initial steps in streamlining and improving the procurement process for both military hardware and commodity items. To date, however, acquisition reform has not addressed the unique problems and requirements associated with service contracts. In order to implement an aggressive outsourcing strategy, DoD must significantly improve its capability to develop, structure, and manage large, complex service contracts.

For example, DoD contracting officers frequently lack adequate expertise in the service being procured. While DoD contracting officers who purchase hardware typically develop expertise in a particular system or commodity area, service contracting is often viewed from a monolithic perspective -- developing a contract for IT services is not considered to be fundamentally different from procuring landscaping services.

Because of this lack of functional expertise, DoD contracting officers in the service area often do not have a comprehensive understanding of the contract terms and conditions that are most likely to be effective for a particular service. This shortcoming also accounts for the tendency of DoD service contracts to include detailed, "how to" military specifications, rather than more flexible performance standards and incentives that encourage vendors to reengineer processes in order to lower costs and improve service delivery.

Moreover, vendors report that DoD continues to base vendor selection primarily on hourly labor rates. Past performance, reputation, and reengineering potential are not generally emphasized in the proposal evaluation process. This emphasis on bid cost contrasts with the private sector's reliance on a "best-value" approach to evaluating potential vendors.

The DoD procurement process also fosters formalized, distant, and sometimes adversarial relationships between vendors and DoD contract oversight personnel. However, private sector experience suggests that an interactive, more collaborative approach is key to effective management of complex service contracts.

Finally, procurement timelines for service contracting remain excessive, and represent a significant constraint to aggressive efforts to expand outsourcing.

# Impediments: DoD Procurement Process

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- Lack of DoD expertise in structuring and managing large, complex service contracts; contract officers:
  - Lack technical expertise in contracted service or good understanding of industry dynamics
  - Lack knowledge of “what works” -- terms & conditions, etc.
  - Often rely on bid cost, not best value, as key selection criterion
- Emphasis on detailed, “how to” specs, rather than on more flexible performance specifications
- DoD often fosters adversarial relationship with contractors, rather than the needed partnership
- d Procurement process timelines too long

### **Impediments: A-76 Process -- Overview**

DoD generally has pursued outsourcing in accordance with Office of Management and Budget (OMB) Circular Number A-76. A-76 was first adopted in 1955 and has been revised periodically over the years. OMB issued its latest A-76 revision in March 1996.

While A-76 states that the official policy of the Federal Government is to rely primarily on the private sector for commercial-type products and services, the document establishes highly formalized, legalistic, and time-consuming procedures for conducting public/private competitions. These procedures favor government entities and ultimately discourage an aggressive DoD strategy to outsource support functions.

The first step in the A-76 process is the development of a Performance Work Statement (PWS) that defines the function subject to public/private competition. After finalizing the PWS, DoD solicits bids and proposals from private vendors. In parallel, the DoD organization that traditionally has performed the function submits a cost proposal, not on the basis of its prevailing cost structure, but on its proposed "most effective organization" (MEO) for performing the function. The MEO may project staff reductions or other cost-saving measures to reduce the costs of performing the competed function.

DoD then compares the contractor proposals with the projected costs of the MEO. Under A-76 rules, DoD may award the contract to an outside vendor only if its bid is more than 10 percent less than projected MEO costs. If the contractor's bid is nine percent less than the projected MEO cost, the workload remains in-house. If the work is retained in-house, the MEO is implemented through the budget process and personnel end strength authorizations.

(There is one exception to the rule that the vendor must submit a bid that is at least 10 percent less than the projected MEO cost in order to win the contract. If the projected savings exceed \$10 million over five years, DoD may award the contract to the vendor even if the differential between the government and private sector bids is less than 10 percent.)

The Services indicate that the A-76 process takes at least 24 months for simple, narrow functions requiring only the submission of sealed bids. More complex or multiple functions involving full technical and cost proposals require 48 months or more.



# Impediments: A-76 Process -- Overview

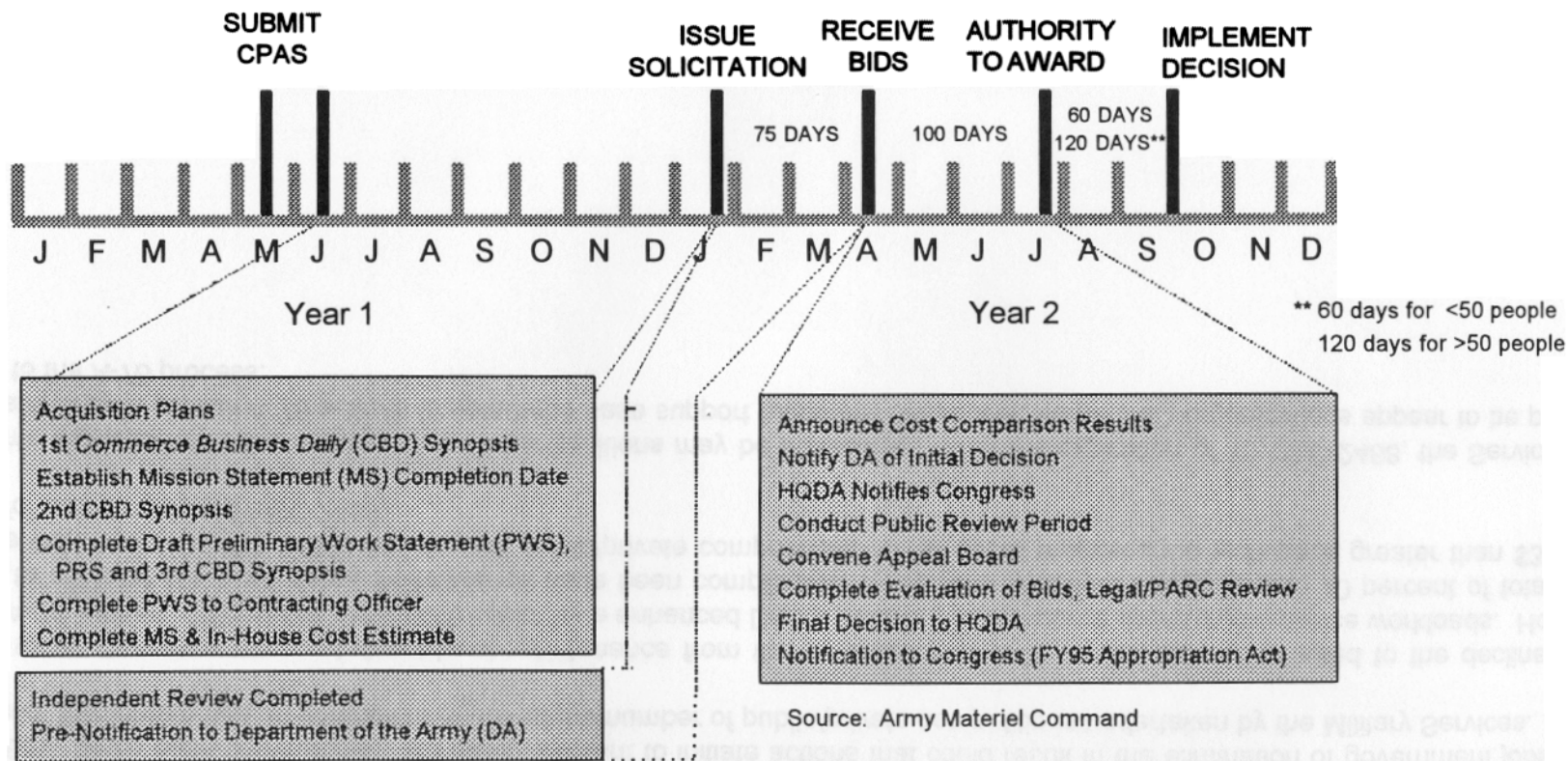
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- ❑ OMB Circular A-76 describes detailed procedures that federal agencies must follow prior to outsourcing functions performed by government employees
- ❑ Mandates public/private cost comparisons prior to outsourcing functions with 10 or more civilian employees
- ❑ Private sector costs are compared against government entity's proposed "Most Efficient Organization" (MEO)
- ❑ Outsourcing proceeds only if private sector cost advantage over MEO exceeds 10%
- ❑ Services/Defense agencies report average timelines of 24 to 48 months to complete A-76 process

**Impediments: A-76 Process -- AMC Timeline**

This slide reproduces the ideal A-76 timeline of the Army Materiel Command for single, relatively narrow functions for sealed bid procurements. Under the best of conditions, such A-76 actions require about two years. More complex, multifunctional procurements requiring the evaluation of full technical and cost proposals have an ideal timeline of 48 months. In practice, this timetable is often delayed by several months. The slide identifies many of the A-76 notifications, reviews, and Congressional reporting requirements that contribute significantly to the extended timelines. AMC is currently reviewing its A-76 process in an effort to compress these timelines consistent with established statutory and OMB requirements.

# Impediments: A-76 Process -- AMC Timeline



*Chart shows ideal schedule for single function, sealed bid; multi-function procurements with full proposals often require 48+ months.*

## **Impediments: A-76 Process -- Declining Number of Competitions**

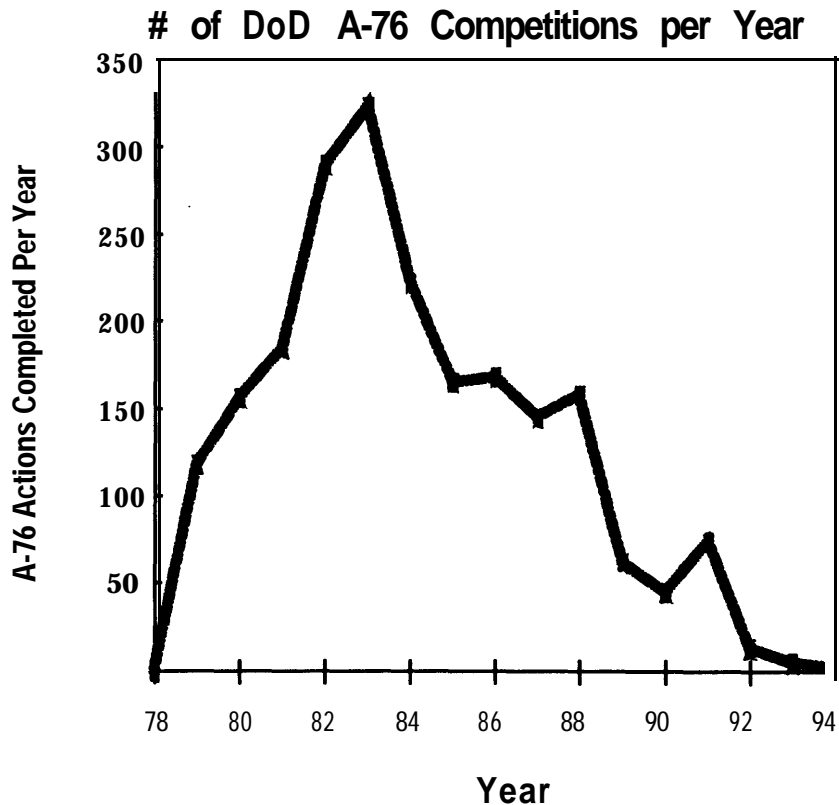
This slide documents trends in the number of A-76 public/private competitions conducted during the 1978-94 period. The number of A-76 actions increased rapidly from nearly zero in 1978 to over 300 in 1983, only to decline in equally dramatic fashion from 1983 to 1994. In recent years, DoD has completed only a handful of A-76 cost comparison studies.

Statutory restrictions have played a significant role in the precipitous decline of A-76 actions over the past decade. For example, in 1989 Congress directed the Secretary of Defense to delegate to base commanders the sole authority to commission A-76 cost comparison studies (10 USC 2468). Since base commanders are often reluctant to initiate actions that could result in the elimination of government jobs under their command, this statute had an immediate effect on the number of public/private competitions undertaken by the Military Services.

In the mid-1980s, Congress removed depot-level maintenance from the jurisdiction of A-76, which also contributed to the decline in the numbers of A-76 actions. This action potentially could have enhanced DoD's flexibility to outsource depot maintenance workloads. However, DoD efforts to contract out more depot maintenance have been complicated by statutes that limit contractors to 40 percent of total depot maintenance workload (10 USC 2466) and require public/private competitions for all depot maintenance workloads greater than \$3 million considered for outsourcing (10 USC 2469).

There is some indication that the number of A-76 competitions may be increasing. With the expiration of 10 USC 2468, the Services now have more authority to pursue A-76 actions to outsource base support functions. Moreover, some DoD organizations appear to be pursuing alternatives to the A-76 process.

# Impediments: A-76 Process -- Declining Number of Comp



Source: Preliminary results of CNA analysis of DoD Commercial Activities data. Includes all Services/Defense Agencies.

- *Statutory restrictions have been the key factor in this decline, which have limited:*
  - *what functions are subject to the A-76 process*
  - *who has the authority to initiate an A-76 review; and*
  - *how much time may be taken to complete the reviews*
  
- *Timelines, up-front costs, and reporting requirements have also discouraged A-76 actions*

### Impediments: A-76 Process -- Key Problem Areas

**Complexity and timelines:** The A-76 process is too complex and requires too much time. A-76 cost comparisons involve extensive documentation and reporting. For large, complex functions, A-76 actions may require 48 months or more before outsourcing decisions are finalized and implemented. Accordingly, A-76 issues often do not receive priority attention, as DoD managers generally prefer to emphasize initiatives that can be accomplished within their two to three year tour of duty.

**Inequitable cost comparisons:** In the view of the Task Force, A-76 public/private competitions are fundamentally inequitable and generally favor the government entity. DoD organizations generally lack the accounting systems and internal controls needed to ensure an accurate allocation of indirect costs. As a result, A-76 competitions may be decided on the basis of government proposals that do not include all relevant costs. (The following slides address this issue in greater detail.)

The playing field tilts in the favor of DoD in other ways. If an outside vendor wins a government contract by “buying in” -- submitting a bid below the cost of performing the service -- the contractor must absorb the loss, even if it jeopardizes the future viability of the firm. In contrast, government organizations never go bankrupt and don’t have to face the risks associated with under-bidding a potential job.

Finally, government entities may propose MEOs whose projected costs bear little relation to its existing cost structure. In light of repeated initiatives to streamline government operations, the Task Force believes that government entities have had ample opportunities to achieve their “most effective organization.” DoD activities that still have failed to implement adequate process improvements should bear the consequences. Eliminating the MEO provision from A-76 would compel government entities to compete on the basis of their prevailing cost structure, while significantly compressing A-76 timelines.

**Inadequate focus on best value:** A-76 competitions focus primarily on proposed public and private sector costs, and in most cases fail to fully consider other important factors such as the bidder’s capability to improve the quality and responsiveness of service delivery. In contrast, private sector firms place considerable emphasis on such non-cost factors when evaluating outsourcing bids. Fortunately, the new A-76 revision gives greater latitude to the government to consider best value. DoD should take full advantage of this new flexibility, and ensure that A-76 competitions focus on selecting the best overall value for the government.

**Small functions:** A-76 actions are focused too narrowly, as each DoD public/private competition affects on average only some 35 government employees. By outsourcing broad business areas, DoD can provide vendors with greater opportunity to reengineer processes -- and greater potential to achieve major improvements in service quality and cost.

**Waivers and exemptions:** A-76 allows DoD to delegate waiver authority to Assistant Secretaries or Defense agency heads.<sup>29</sup> Such waivers eliminate the requirement for formal public/private competitions. Under current A-76 rules, the Secretary of Defense or designee may also authorize the contracting out of any support function without A-76 cost comparisons “when required to assure the national defense.”<sup>30</sup> DoD reportedly has never exercised its waiver authority or claimed the national security exemption. The Task Force urges DoD to take full advantage of this flexibility to jump-start the Department’s outsourcing initiative.

# Impediments: A-76 Process -- Key Problem Areas

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- d Complexity & timelines
- Inequitable public/private cost comparisons
- d Emphasis on cost, not best value
  - Service quality issues usually receive little consideration
- Affects mostly small, stovepiped functions
  - Impacts average of 35 government employees
- Exemptions and waiver authority not used adequately

### **Impediments: Poor Government Cost Data**

Federal government cost accounting systems are designed to support the government budget process and to facilitate reporting to Congress. However, these government entities do not have in place the business systems and internal controls to properly measure and allocate indirect costs.<sup>31</sup> Accordingly, government bids may not reflect the full cost of performing the competed function, thus undermining the basic premise of public/private competition.

Many state and local governments face similar problems in implementing public/private competition. As noted on page 28, Indianapolis and other jurisdictions have used activity-based costing (ABC) to identify all of the government costs associated with performing specific functions. ABC is a relatively low cost, responsive tool that may be used to supplement existing accounting systems to provide accurate cost information, including the proper allocation of indirect and overhead costs.



# Impediments: Poor Government Cost Data

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- ❑ Government cost accounting systems designed for control, reporting to Congress -- not managing enterprises
- ❑ Generally inadequate to support realistic cost comparisons with the private sector
- ❑ Key problem: identification and allocation of indirect costs
- ❑ Industry and state/local governments use activity-based costing (ABC) to perform meaningful cost comparisons
- ❑ ABC can be implemented quickly in any DoD activity to provide realistic estimates of government costs

### **Impediments: Poor Cost Data – ABC Provides Cost Comparison Tool**

This slide illustrates the basic concept of activity-based costing. Traditional accounting systems track costs by selected “buckets” such as salaries, benefits, travel expenses, etc. However, these systems do not link cost information to meaningful outputs. In other words, traditional accounting systems do not help managers determine whether resources are being utilized in a cost-effective manner.

In contrast, ABC allows managers to identify all of the costs associated with specific processes, and thus to calculate the “true” costs associated with producing a given product or service. Resources are linked to processes and outputs primarily through a series of structured interviews with company personnel that directly produce or support the production of the product or service in question. These interviews may be conducted by a management team or outside consultant. In most cases, ABC assessments can be completed in several weeks to a couple of months with minimal investment.

In the private sector -- and increasingly in government as well -- ABC has become a highly effective tool for understanding and managing costs. The Task Force believes that ABC could greatly enhance the credibility of government cost estimates and eliminate a major inequity in public/private competitions as currently practiced.

# Impediments: Poor Cost Data -- ABC Provides Cost Comparison Tool

Traditional vs. Activity-Based Costing (ABC) Perspective for Notional Government Organization

<i>Traditional Accounting Perspective</i>		<i>Activity-Based Perspective</i>	
Salaries & Benefits	\$870,000	Collect Data	\$69,000
Travel Expenses	3,000	Validate Data	404,000
Facilities/Phones	140,000	Create Monthly Camera Copy	23,000
Contractual Services	93,000	Print Monthly Report	69,000
Printing & Repro.	1,000	Manage HR	92,000
Training	6,000	Perform Admin. Functions	104,000
Health Units	3,000	Perform System Admin.	92,000
Supplies	1,000	Provide/Attend Training	69,000
Equipment	2,000	Perform Special Projects	115,000
TOTAL	\$1,119,000	Report Accounting Data	82,000
		TOTAL	\$1,119,000

*ABC provides a practical tool for identifying the total costs of a given service, & should be the standard approach for conducting public/private cost comparisons.*

### **Impediments: Concept of “Core” Support**

Although many senior DoD and Service leaders favor shifting more depot-level maintenance/overhaul to private contractors, DoD cannot outsource more than 40 percent of total depot maintenance workload. This restriction is based on 10 USC 2464 (which requires that DoD maintain in-house “core” logistics capabilities needed to support mission-essential DoD systems) and 10 USC 2466 (which essentially defines “core” as 60 percent of depot-level maintenance workload).

The Task Force strongly recommends that DoD base source of repair decisions for mission-essential workloads solely on the capability and reliability of the service provider. Responsiveness and assurance are the key factors that should guide DoD workload allocation decisions. In our opinion, the issue of public or private ownership has little if any bearing on the capability of the maintenance organization to support DoD mission-essential requirements.

The Task Force recommends that DoD seek the revision or elimination of 10 USC 2464 and 10 USC 2466 to allow contractors with the appropriate capabilities and a history of reliable support to perform mission-essential workloads. All arbitrary restrictions such as the 60/40 requirement should be removed, as such requirements result in an inefficient allocation of DoD maintenance resources.

The Task Force acknowledges that some specialized workloads should be reserved for the organic depots, such as maintenance and deactivation of nuclear propulsion systems. DoD should identify such exceptions based on a careful review of the merits of each case. Although it is unclear what organic facilities will be needed to support such specialized requirements, the Task Force believes that this residual capability should be much smaller than the present organic infrastructure.

# Impediments: Concept of "Core" Support

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- Legislation requires that DoD maintain “core” logistics capabilities to support mission-essential systems
  - 10 USC 2464: core work must be performed in-house
  - 10 USC 2466: 60/40 depot maintenance split
  
- Source of repair decisions for mission-essential workloads should be based solely on **capability & reliability**
  - Responsiveness and assurance key -- not public vs. private
  - Allow contractors with needed capabilities & history of reliable support to perform mission-essential workloads
  - Remove arbitrary restrictions such as 60/40
  
- Some organic capability should be retained to support unique requirements (e.g., nuclear propulsion)
  - How much is unclear -- well below current 60% restriction
  - DoD should make decision based on merits

### **Impediments: DoD Culture/Lack of Incentives**

The DoD culture is an important impediment to the implementation of an aggressive outsourcing strategy. DoD has a remarkable history of military achievement; this history has also resulted in an entrenched culture that resists dramatic departures from well-established patterns of behavior.

In the current environment, there are few incentives for the Military Services to pursue an aggressive outsourcing program. Base commanders are not evaluated on their effectiveness in outsourcing support functions and, in fact, are predisposed to protect the job security of their staff. Moreover, the Military Services fear that savings achieved from outsourcing are likely to be diverted to support other DoD requirements, and may not be available to the outsourcing organization to fund modernization or other Service needs.

The DoD culture reflects the emphasis of the Services on their primary mission: to prepare for and fight wars. Because of this focus on military readiness, the Military Services understandably emphasize the need for reliable and effective support. Traditionally, this orientation has translated into a strong preference for in-house support organizations. In some cases, readiness arguments have been used to forestall greater reliance on the private sector, even in some cases in which it was not apparent that the use of outside vendors would actually have a negative impact on military capabilities.

There is also substantial skepticism that DoD has actually embraced a new paradigm for obtaining support services. To many, "outsourcing" is just the latest in a series of favored buzzwords that fade from view after the next election or change of DoD leadership. To counter this skepticism, senior DoD officials must undertake a sustained effort to persuade the institution that outsourcing is critical to DoD's ability to execute its warfighting mission.

# Impediments:

## DoD Culture/Lack of Incentives

- ❑ Conservative, risk-averse culture
- ❑ Strong resistance to change -- outsourcing represents dramatic departure from well-established practices
- ❑ Few incentives
  - Timelines of A-76 process very long -- two to four years
  - Activities seldom permitted to retain outsourcing savings for modernization & other needs
  - Base commanders are not evaluated on outsourcing success, predisposed to protect job security of staff
- ❑ Readiness, wartime, and rotation base concerns result in preference for in-house support
- ❑ Skepticism of new initiatives -- is “outsourcing” a real paradigm shift or merely the latest buzzword?

### Briefing Outline: Proposed Strategy

This section summarizes the key elements of an aggressive DoD strategy to outsource most support functions, and proposes a DoD-wide outsourcing savings goal.

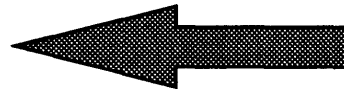
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# Briefing Outline

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- Background
- The Challenge
- Private Sector Experience
- Public Sector Experience
- Primary Impediments
- **Proposed Strategy**
- Recommendations



## Proposed Strategy: Key Elements

This slide summarizes key elements of an aggressive strategy to outsource most DoD support functions.

**Change presumption:** Today, the presumption is that DoD support functions will be performed by internal organizations in the absence of a compelling reason to contract out a particular support service. DoD must abandon this costly, outmoded bias in favor of organic support. DoD should outsource all support functions that can be performed cheaper and/or more effectively by the private sector -- except inherently governmental activities or those functions that directly impact warfighting capabilities.

**Reduce reliance on A-76:** DoD should greatly reduce its emphasis on the A-76 process and public/private competition as the Department's primary outsourcing tools. The Task Force believes that A-76 is seriously flawed and discourages outsourcing. DoD should use business case analysis, not public/private competition, as the primary vehicle for identifying outsourcing candidates.

The Task Force recommends that DoD avoid A-76 procedures whenever possible by taking full advantage of both the existing waiver authority and the national defense exemption. To date, DoD reportedly has never exercised its waiver authority or claimed the exemption.

Senior DoD officials should use their management authority to eliminate the internal capability to perform most functions that do not directly impact the Department's warfighting mission. In the view of the Task Force, policy decisions to "get out of the business" of performing certain support functions are within the purview of DoD management. Senior DoD officials should issue A-76 waivers if necessary to carry out this large-scale streamlining of the DoD support structure.

The Task Force also urges the Services to extend outsourcing efforts to those support functions performed primarily by military personnel, who are not covered by A-76 procedures. By outsourcing military billets, the Services can maximize savings -- up to 50 percent of function costs.

**Broad functions:** DOD traditionally has outsourced "low tech," narrow functions, thereby limiting the potential for process improvement and cost reduction. The Task Force urges the Department to focus on more large, more complex business areas involving thousands of government personnel. This more aggressive approach provides vendors with maximum opportunity to reduce costs and improve service delivery through the application of innovative technologies and business practices.

**Reform A-76:** Since A-76 may represent in some cases the only practical means of transferring support functions to the private sector, DoD should continue its efforts to expedite the process and render public/private competitions more equitable for private sector bidders.

**Eliminate impediments:** Senior DoD officials must give priority attention to removing statutory and institutional impediments to the effective implementation of an aggressive outsourcing initiative.

**Develop implementation plan:** DoD needs a detailed implementation plan with aggressive outsourcing targets and milestones. Senior DoD managers must be held accountable for achieving outsourcing objectives.

# Proposed Strategy: Key Elements

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Establish presumption for outsourcing

- Reduce reliance on A-76
  - Take full advantage of waivers and exemptions
  - Make policy decisions to “get out of business”
  - Focus on military billets: high pay-off, no A-76
- Since some A-76 actions may still be necessary, expedite process & “level the playing field”
- Outsource broad support functions
- Eliminate statutory & institutional impediments
- Establish implementation plan with aggressive targets and milestones -- hold senior managers accountable

### **Proposed Strategy: Goal for FY 2002**

The Task Force urges DoD to establish the goal of shifting \$7 to \$12 billion in outsourcing savings from support to modernization by fiscal year 2002 (FY02). In the view of the Task Force, this goal provides a strong rationale and focus for DoD's outsourcing initiative. The following discussion provides the Task Force rationale for this savings goal.

The DoD Commercial Activities Inventory Data Base indicates that there are approximately 640,000 DoD civilian and military FTEs engaged in commercial-type activities. As noted in previous sections of this report, this number is probably understated by a considerable margin. Nevertheless, the Task Force has used this conservative figure as the basis for its savings estimate.

The Task Force assumes that these FTEs have a fully loaded cost of about \$70,000 per man-year. This rate is based on the Task Force's estimate of average salary, benefits, and overhead costs per person. Accordingly, the 640,000 commercial activity FTEs represent a total cost to DoD of almost \$45 billion per year.

The Task Force believes that an aggressive DoD outsourcing initiative could result in the transfer of one half to two thirds of all commercial activity workload to private vendors by FY02. The cost of performing this workload with government personnel is about \$23 to \$30 billion per year.

As noted on page 32, A-76 actions have resulted in average savings of about 30 percent of function costs. If the Department achieves comparable gains and succeeds in contracting out 320,000 commercial FTEs by FY02 -- only half of the total documented commercial activity FTEs -- the Department will realize total savings of about \$7 billion per year. [ $\$23 \text{ billion} \times 30 \text{ percent} = \$6.9 \text{ billion}$ ] However, this estimate may be conservative, since the 30 percent savings rate reflects the suboptimal A-76 approach.

The Task Force believes that DoD could significantly improve this savings performance by outsourcing broad, more complex support functions and by utilizing performance-based contracting strategies that provide vendors with a strong incentive to reduce costs through the use of innovative technologies and business practices. The Task Force believes that savings of at least 40 percent of function costs are feasible under this more aggressive outsourcing approach. If DoD achieves this rate of return and contracts out two thirds of documented commercial FTEs, outsourcing savings would total about \$12 billion annually. [ $\$30 \text{ billion} \times 40 \text{ percent} = \$12 \text{ billion}$ ]

In other words, the Task Force projects potential annual savings of about \$7 to \$12 billion by FY02. Although ambitious, such savings are realistic and achievable. As noted on page 32, DoD A-76 actions have generated \$1.5 billion in annual savings, despite the shortcomings of this approach and the lack of A-76 activity in recent years. A more aggressive DoD initiative will yield proportionally greater benefits.

# Proposed Strategy: Goal for FY 2002

- d Shift **\$7-12 billion** in outsourcing savings from support to modernization by FY02
  - Provides 30% increase in procurement funding
  - Gives focus & rationale for outsourcing initiative
- Calculation of potential savings:
  - 640K FTEs X \$70K per man-year = \$45 B per year
  - **Low range:** 320K FTEs X 30% savings rate = \$7B
  - **High range:** 430K FTEs X 40% savings rate = \$12B
- Achieve savings related to outsourcing actions, e.g. direct vendor programs resulting in lower inventory costs

*Savings could be significantly higher than \$12 billion if DoD capitalizes on all outsourcing opportunities.*

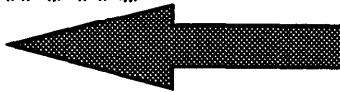
### **Recommendations: DoD-Wide**

This section describes the Task Force recommendations. These actions represent key elements of an aggressive outsourcing strategy. The recommendations are divided into three groups. *DoD-Wide* recommendations relate to policy, management, and organization issues. *Functional Area* recommendations address specific issues relevant to logistics, finance and administration, base activities, and other support functions. *Proposed Early Actions* refer to those measures that the DoD leadership should implement immediately.

# Briefing Outline

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- Background
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- **Recommendations**
  - DoD-Wide
  - Functional Areas
  - Proposed Early Actions



### DoD-Wide Recommendations: Policy

Since the 1950s, it has been the declared policy of the U.S. Government not to use government employees to perform work that could be conducted as well or better in the private sector. The existence of an array of organic DoD support organizations suggests that the Department has often deviated from this policy.

The Task Force recommends that the Secretary of Defense reiterate in a formal policy statement that the private sector is the preferred provider of support services to DoD. The Secretary should stress that all non-combat support services must be considered for outsourcing except those functions that are inherently governmental or for which no adequate and competitive private sector capability exists or can be expected to be established. The Secretary should also emphasize these principles in his public pronouncements.

In the view of the Task Force, "non-combat" functions may include a variety of support services typically provided within the theater of operations. The experience of Desert Shield/Desert Storm, Haiti, Bosnia and other recent deployments suggest that contractors can and do provide reliable, essential in-theater support services. "Combat" support functions should be defined only as those front-line battlefield support services that are likely to expose support personnel to direct enemy fire. The concept of "inherently governmental" should also be interpreted narrowly and limited to policy development, requirements generation, strategic planning, contract management, budget preparation, and similar management functions.

Senior DoD officials should also take appropriate measures to ensure that the Services can retain outsourcing savings for investment and modernization. The Services should determine the allocation of savings to subordinate commands; however, activities that meet outsourcing targets ought to receive some of the benefits. Savings obtained from contracting out defense agency functions should be distributed to the Services and DoD acquisition programs. While the Deputy Secretary recently issued a letter assuring the Services that they will be able to retain outsourcing savings, there is still some concern that these resources could be diverted over time to satisfy other pressing DoD requirements.

The DoD leadership must also adopt as a top priority the need to remove the primary statutory impediments to an aggressive outsourcing strategy, including the requirement to perform detailed public/private cost comparison studies prior to making an outsourcing decision and the "60/40" restriction on depot-level maintenance. An effective outsourcing program will be difficult if not impossible to implement unless these impediments are removed or at least greatly diminished. DoD submitted a legislative package to Congress in April 1996; senior DoD officials should view the passage of these reforms as a key priority of the Department.



# DoD-Wide Recommendations: Policy

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- ❑ SecDef should issue a policy statement reiterating that the private sector is the preferred provider of support services
- ❑ Statement should emphasize that all non-combat support services must be considered for outsourcing except:
  - Services that are inherently governmental
  - Services for which no adequate private sector capability exists or can be expected to be established
- ❑ Senior DoD officials should implement measures to ensure that the Services will retain savings for modernization
  - 2196 DepSecDef memo is a positive step -- but follow-up action is needed
- ❑ Senior DoD officials should view passage of proposed legislative package as a key Department priority

### **DoD-Wide Recommendations: Leadership**

DoD leadership must persuade the institution that it is committed to implementing an aggressive outsourcing program, and that outsourcing is critical to the long-term combat effectiveness of U.S. military forces. Senior officials must emphasize that outsourcing is not merely the latest buzzword or management fad that is likely to fade after the next election or change in Department leadership. Communicating this message in a persuasive manner is critical to the success of this initiative.

Accordingly, senior DoD officials must also exercise strong and sustained leadership on outsourcing issues. As the primary manager of the Department's internal operations, the Deputy Secretary of Defense has unique authority, prestige, and opportunity to promote the implementation of an aggressive outsourcing strategy. His commitment to this initiative must be sustained, highly visible and results-oriented. Other senior OSD and Service officials must also view outsourcing as a continuing priority. Strong top-down support for a fundamental shift in DOD business practices will be needed to overcome mid-level resistance to change.

There is also a need for a permanent outsourcing champion within OSD with day-to-day responsibility for addressing DoD-wide issues such as legislative and regulatory outsourcing barriers. This individual, who should be at least an Assistant Secretary or Deputy Under Secretary, should also serve as a central source of information on outsourcing procedures and outcomes. Appropriate senior officials in each of the Services should perform a similar role.

The Task Force recommends that DoD and the Services establish clear, concrete outsourcing targets and milestones. These objectives should be communicated clearly to cognizant managers, who must be held accountable for achieving these goals. Officials who meet outsourcing targets should be rewarded with promotions and desirable assignments.

Finally, the Task Force once again recommends that senior DoD leadership place strong emphasis on working with Congress to resolve the statutory impediments to outsourcing. An aggressive outsourcing program requires the elimination of these obstacles.

# DoD-Wide Recommendations: Leadership

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- ❑ DoD leadership must convince the institution that the shift to an outsourcing paradigm is permanent & real
- ❑ DepSecDef's role in outsourcing initiative must be sustained, highly visible, and results-oriented
- ❑ DepSecDef should designate an OSD champion for outsourcing at the Assistant Secretary level or higher
- ❑ Senior OSD/Service leadership must establish clear expectations for subordinates -- targets & milestones
  - Hold senior managers accountable for achieving goals
- ❑ Personal involvement and commitment of top leadership needed to resolve Congressional issues
  - 60/40 requirement, A-76-related statutes

## DoD-Wide Recommendations: A-76 Process/Cost Comparisons

OMB Circular A-76 mandates a cumbersome, time-consuming, and legalistic process that discourages DoD activities from initiating outsourcing actions.

The Task Force recommends that senior DoD officials take full advantage of their authority to waive the requirement for formal public/private competitions under existing A-76 rules. Such waivers allow DoD to use business case analysis to identify and assess outsourcing candidates, greatly simplifying the outsourcing process and eliminating the built-in government bias that is inherent to public/private competitions.

In the past, senior DoD officials have been reluctant to exercise the waiver/exemption authorities granted to the Department under the existing A-76 rules. By capitalizing upon this flexibility, DoD leaders can demonstrate that the Department is determined to streamline its outmoded and costly support infrastructure.

Moreover, when possible and appropriate, senior DoD managers should make the policy decision to “get out of the business” of performing particular support functions with government employees. In the view of the Task Force, such decisions are within the purview of DOD management and can be made outside the A-76 process.

Since A-76 will be on some occasions the only practical approach to outsourcing support functions, the Task Force recommends that DOD continue to work closely with OMB to streamline the current A-76 process. In March 1996, OMB issued its latest revision to OMB Circular A-76. Depending on how the changes are implemented, this revision may address some of the shortcomings of the current process. However, the Task Force believes that a more far-reaching and comprehensive reform of A-76 is required.

Future reform efforts should focus on modeling A-76 procedures on the private sector make/buy decision process. The A-76 process must be simplified and its timelines shortened. The detailed administrative procedures established by A-76 should be made advisory, not mandatory, allowing DoD components to structure appropriate processes tailored to their specific circumstances. DoD should also push for reform measures that “level the playing field” in A-76 competitions by improving public/private cost comparisons. The Task Force recommends that DoD utilize impartial third parties to conduct activity-based costing (ABC) analyses of DoD activities involved in public/private competitions to ensure the proper identification and allocation of all indirect costs.

The Task Force also notes that there appear to be significant differences in the way that the Services and defense agencies implement A-76 requirements. These differences result in widely divergent A-76 timelines. The Task Force strongly recommends that the Services and defense agencies work together to identify the most effective and expeditious approaches to implementing A-76 requirements.

# DoD-Wide Recommendations -- A-76 Process/Cost Comparisons

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- ❑ DoD should take full advantage of its A-76 waiver authority to avoid formal public/private competitions
- ❑ Current OMB revisions appear positive, but further reform is needed to:
  - Reduce A-76 complexity, timelines
  - Make A-76 procedures advisory, not mandatory
  - Pattern A-76 on private sector make/buy decision process
- ❑ The Services should identify and employ best practices to expedite the A-76 process
- ❑ Deploy activity-based costing (ABC) tools in those activities targeted for A-76 actions

In the view of the Task Force, an aggressive DoD initiative to outsource support functions requires significant improvements in the Department's capabilities to structure and manage complex service contracts.

To date, the Department's acquisition reform efforts have focused primarily on streamlining the processes associated with the acquisition of military systems and the procurement of commercial-type products. In contrast, less emphasis has been placed on improving service contracting, which accounts for about \$40 billion annually -- a figure that is likely to increase rapidly as DoD moves forward with outsourcing.

The Task Force recommends that the Department identify service contracting as a high priority on DoD's acquisition reform agenda. OSD should establish a Tiger Team to develop a near-term plan for improving service contracting procedures and capabilities. This plan should address the need for appropriate contract templates for a range of outsourced services. Moreover, the plan should ensure that contracting officials develop an adequate understanding of the technology, trends, and dynamics of the industry providing the service.

Private sector experience demonstrates that, in successful outsourcing relationships, both the outsourcing firm and the vendor share a strong common interest in cost reduction and quality improvement. This alignment of interests is achieved through the use of output-oriented performance incentives which allow the vendor to benefit from measurable performance improvements. The Task Force believes that the use of such incentives is key to a successful outsourcing program.

In the view of the Task Force, outsourcing is most effective when a range of base support functions are consolidated under a single contract for integrated facility management services. This contracting approach (which typically involves a prime contractor supported by an extensive team of subcontractors) streamlines project management and oversight; maximizes the opportunities for process reengineering; promotes synergies among contracted functions; and achieves greater efficiencies and quality of service.

The Task Force also recommends that DoD pattern its approach to oversight on commercial practice. In the private sector, the outsourcing firm typically utilizes a small oversight team with extensive expertise in the work being performed; is co-located with the vendor at the work site; and interacts closely with the vendor on a day-to-day basis. The oversight team seeks to foster an interactive, collaborative relationship -- not the adversarial environment that often accompanies DoD oversight.

Finally, the Task Force believes that market forces are key to ensuring that vendors deliver low cost, high quality support. DoD can maintain a competitive environment through periodic recompetitions, by maintaining more than one supplier for a given support function, and/or by utilizing performance incentives that encourage cost reductions and service improvements. The Task Force notes that there are a wide range of possible vendors for most DoD support functions, significantly limiting the concern that DoD may become excessively dependent upon any single contractor for a particular support service. Finally, successful outsourcing contracts are long-term partnerships; in the private sector, service contracts have an average period of performance of five to ten years. However, DoD should retain the right to cancel such contracts at any time for poor performance.

# DoD-Wide Recommendations: Contracting

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- ❑ Expand DoD acquisition reform efforts to include service contracting; form Tiger Team to develop near-term plan
- ❑ Employ output-oriented performance incentives in service contracts to align the interests of DoD & vendor
- ❑ Use integrated facility management approach when outsourcing base support functions
- ❑ Minimize oversight personnel, and forge close interactive relationship with contractor
- ❑ Employ long-term contracts, but include cancellation clause

### DoD-Wide Recommendations: Personnel

DoD installations around the country are often the largest single source of employment in their respective regions. Resistance to outsourcing in Congress and other quarters reflect concern regarding the potential impact of outsourcing decisions on local communities. The relatively concentrated and highly visible nature of this potential dislocation increases the likelihood of Congressional resistance to large-scale outsourcing of DoD support services.

Accordingly, it is critical that DoD address such personnel matters proactively, well before the final outsourcing decision is announced. While government workers are unlikely ever to welcome outsourcing initiatives, early and continuous communication with public employees and their union representatives is needed to avoid misunderstandings and to facilitate the outsourcing transition. DoD should emphasize that most vendors hire a substantial number of the affected workers, and that many of these employees flourish in the new environment. Attrition and relocation should be the preferred strategies for downsizing the DoD workforce; reductions-in-force (RIFs) should be viewed as a last (but sometimes necessary) alternative.

In the view of the Task Force, DoD should provide affected employees with appropriate transition assistance in the form of re-training, outplacement, and severance packages consistent with commercial practice. However, DoD should not impose any requirements on vendors such as mandatory portability of benefits that would restrict the flexibility of the contractor to provide efficient and cost-effective support.

Unless the impact of outsourcing on people and jobs is effectively addressed, it is unlikely that the political impediments to outsourcing will be reduced significantly. This issue must receive the highest degree of attention from the senior DoD leadership, who must recognize the need for investment in re-training and outplacement in order to smooth the transition process and ensure that displaced staff are treated fairly and with compassion.



# DoD-Wide Recommendations: Personnel

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- ❑ Address personnel matters proactively, seek early involvement of unions
- ❑ Provide early, open, and sustained communication
- ❑ Provide adequate retraining, outplacement, and severance packages consistent with industry practice
- ❑ Use attrition to downsize workforce when possible
- ❑ Focus senior DoD leadership attention on personnel transition issues to facilitate the removal of political impediments to outsourcing

### Recommendations: Functional Areas

This section summarizes the Task Force recommendations. These recommendations are based on the work of the four Task Force working groups, which analyzed outsourcing issues in logistics, finance and administration, defense agencies/DOD activities, and base activities. These working groups met independently from November 1995 through January 1996 to review on-going DoD initiatives in these functional areas, interview appropriate DoD officials and private sector representatives, and formulate working group recommendations.

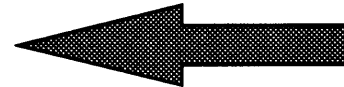
DoD is pursuing various outsourcing initiatives in each of these functional areas. However, the Task Force has concluded from its review that these efforts are often fragmentary, focused primarily on narrow functions, and lack adequate management support. Moreover, many DoD activities have put off outsourcing actions until after they have completed efforts to improve the processes to be outsourced, an approach that delays the transfer of the function to the private sector and could saddle the vendor with inferior processes.

In the view of the Task Force, the current DoD approach to outsourcing is not fully effective. In order to reduce support costs by the extent required to meet DoD's modernization requirements, the Department must undertake a fundamental paradigm shift that transforms its approach to acquiring support services.

# Briefing Outline

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- ❑ Background
- ❑ The Challenge
- ❑ Private Sector Experience
- ❑ Public Sector Experience
- ❑ Primary Impediments
- ❑ Proposed Strategy
- ❑ Recommendations
  - DOD-Wide
  - Functional Areas
  - Proposed Early Actions



## Functional Area Recommendations: Logistics

The Task Force working group on logistics focused its analysis primarily on materiel management, depot maintenance, and sustaining engineering. As noted in a previous section of this report, the Task Force believes that DLA is moving forward with innovative strategies in the material management area -- such as direct vendor delivery and prime vendor contracts -- which allow DoD to capitalize on commercial capabilities to reduce material costs and delivery lead-times. The Task Force encourages DLA to apply such approaches broadly throughout the materiel management function.

In the depot maintenance area, the Task Force recommends that DoD base source of repair decisions solely on the capability and reliability of potential service providers, even for mission-essential workloads. The Task Force sees little validity in the argument that certain depot maintenance workloads must remain in the organic sector to ensure military readiness of "core" weapon systems. For many years, contractors have demonstrated the capability to perform such work, as well as the willingness to respond rapidly to military requirements in emergency situations. Accordingly, the Task Force strongly recommends that DoD discard the concept of core depot maintenance requirements or modify the concept to allow contractors with the necessary capabilities to perform mission-essential workloads.

The Task Force also believes that the Services should rely primarily on contractors to provide depot-level maintenance for new weapons systems. This policy would allow DoD to avoid the up-front costs of establishing organic capability to perform depot-level maintenance on complex new weapon systems. Moreover, this approach permits a gradual drawdown of personnel in the organic depots, thereby softening the economic impact of outsourcing on local communities as well as its political impact on Capitol Hill.

The history of public/private competition in the depot maintenance area has been contentious. A 1995 analysis by Coopers & Lybrand, L.L.P. concluded that such competitions are inherently unfair to private sector bidders because government depots lack adequate accounting systems and internal controls to identify and properly allocate all indirect costs associated with competed workloads.<sup>32</sup> As a result of this finding, DoD prohibited further public/private competitions for depot-level maintenance until the government depots have the capability to provide accurate and complete cost data. The Task Force supports this decision and urges DoD to continue this prohibition.

As noted on page 19, the commercial airlines are placing increasing emphasis on "power-by-the-hour" service agreements for key aircraft components such as landing gear, auxiliary power units, engines, and tires. Under such arrangements, the airlines purchase performance (as measured by flying hours, landings, engine cycles, or other event) from vendors, rather than mere parts or labor hours. Power-by-the-hour gives the vendor a strong incentive to improve reliability, transfers the responsibility for inventory management from the operator to the vendor, and provides the operator with greater maintenance cost predictability.

In light of this private sector experience, the Task Force believes that power-by-the-hour concepts have significant potential for reducing the cost of spare parts and improving the reliability of DoD weapon systems. While there are significant challenges involved in structuring effective power-by-the-hour agreements, the Task Force urges the Services to identify opportunities to employ this approach.

# Functional Area Recommendations: Logistics

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- ❑ Base depot-level maintenance source of repair decisions on capabilities, reliability, & responsiveness only
- ❑ Discard concept of “core” logistics requirements, or redefine to allow reliable contractors to perform “core” work
  - d Use contractor logistics support for new systems
- ❑ Continue the ban on public/private competition in depot-level maintenance
- ❑ Work with Congress to remove statutory restrictions on outsourcing such as 60/40
- ❑ Increase use of “power by the hour” arrangements with contractors for component repair
  - Contract for performance, not just for spare parts or repairs

### **Functional Area Recommendations: Logistics (continued...)**

The Task Force recommends that DoD also outsource most sustaining engineering for aircraft and other major weapon systems. In the commercial sector, original equipment manufacturers (OEM) like Boeing, McDonnell Douglas, and General Electric maintain large product support engineering staffs which perform much of the sustaining engineering function for their customers. Moreover, airlines and other commercial operators are increasing their reliance on OEM product support capabilities.

In the defense environment, contractor engineers involved in the initial design and production of the weapon system are in the best position to perform the sustaining engineering function. In most cases, sustaining engineering responsibilities currently are performed by DoD engineers who have had no significant involvement in the development of the original system design. The Task Force believes that DoD should shift responsibility for sustaining engineering on most weapon systems to the OEMs. This shift would help contractors sustain their core engineering capabilities during periods when there are few program start-ups.

The Task Force strongly urges DoD to avoid privatization-in-place (PIP) as a strategy for outsourcing DoD support functions. Under this approach, DOD transfers the organic facility, workload, and workforce to a single contractor or group of contractors. The contractor or contractors are obligated to perform that workload in the transferred facility. As a result, PIP often results in the artificial preservation of surplus capacity and the suboptimal utilization of resources.

However, the Task Force recognizes that PIP may in a small number of cases represent the only practical means of transitioning organic workload to the private sector. When this approach is the only acceptable alternative, DoD should ensure that PIP is implemented in a way that allows the contractor to maintain maximum flexibility over workload and personnel issues. In particular, DoD should ensure that the contractor faces no barriers to bringing commercial work into the military facility, allowing more efficient capacity utilization. Nor should DoD impose the government cost structure upon the contractor by requiring the firm to follow the government wage scale or insisting upon mandatory portability of pension obligations and other fringe benefits.

Concepts developed by DLA to circumvent the DoD supply and transportation system have significantly reduced material costs and have improved service, especially delivery times. Implementation of these concepts also resulted in lower inventory levels, with a consequent decrease in infrastructure and personnel costs as well as substantial one-time savings. DLA's positive experience suggests that the Service supply systems should implement these new concepts as well.

# Functional Area Recommendations: Logistics (continued...)

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- ❑ Outsource sustaining engineering for most major weapon systems
- ❑ Avoid Privatization-in-Place (PIP) as this approach often results in the preservation of surplus capacity
- ❑ However, when PIP is the only practical alternative during transition, ensure that contractors
  - Have maximum flexibility over workload & personnel
  - Are free to bring commercial work into the military facility without restriction
- ❑ Greatly expand the innovative supply management practices pioneered by DLA (e.g. prime vendor contracts and direct vendor delivery) to the Service supply systems

## Function Area Recommendations: Defense Agencies/Activities

Defense agencies and other common support activities are strong outsourcing candidates. The Task Force has identified several such activities/functions that should be outsourced immediately. These proposed actions should be viewed as only initial steps leading to the outsourcing of most support functions currently performed by defense agencies and other common support organizations.

**Commissary system:** The Defense Commissary Agency (DeCA) operates 312 commissaries at military installations in the United States and overseas which serve active and retired military personnel and their dependents. Annual sales total about \$5.5 billion, making DeCA the ninth largest grocery chain in the United States. DeCA customers are subsidized by DoD through a variety of mechanisms and do not pay for the full cost of commissary operations. While DeCA has undertaken a range of initiatives in recent years to streamline its operations, the Task Force believes that outsourcing the commissary function to one of the nation's leading grocery or retail chains would enhance DoD's market power and allow the negotiation of more favorable prices from suppliers. The contractor would be required to maintain prices below market levels and would receive a subsidy (although smaller than currently provided) for this purpose.

**Data center operations:** The Defense Information Systems Agency (DISA) currently operates 30 "data megacenters" which perform DoD's centralized information processing functions. (DISA plans to consolidate these megacenters into 16 facilities by FY97.) DISA has a staff of 5,800 government employees and an annual budget exceeding \$700 million. In the private sector, firms routinely outsource data center operations to reduce costs and gain access to new technologies and skilled workers. A recent analysis of DISA megacenter operations concluded that DoD could achieve \$1.25 billion in savings from 1996-2006 through outsourcing and further consolidation, with no negative impact on service delivery.<sup>33</sup> This analysis indicates that DISA unit costs total approximately \$111 per IBM CPU, compared to an industry average in the \$55 to \$65 range. Currently, DISA outsources 10% of its core technical workload, representing about 7% of its total budget.

**Finance/accounting:** The Defense Finance and Accounting Service (DFAS) performs DOD-wide accounting, payroll, travel reimbursement, invoicing, debt management, and other support functions. DFAS has a FY96 operating budget of \$1.8 billion and a staff of 25,000. Since such functions are routinely performed in the private sector by a range of outside vendors, the Task Force believes that DoD should move immediately to outsource as many of these functions as possible. For example, DFAS charges \$7.25 and \$10.22 per person per month to administer DoD's primary military and civilian payroll accounts, respectively, while industry payroll service rates range from \$1.60 to \$3.20. Although industry rates would not cover all of the accounting functions performed by DFAS, such additional services are available in industry and the cost will almost certainly be below that charged by DFAS. Current DFAS outsourcing initiatives focus on relatively narrow functions which account for a small portion of the total workload. Unfortunately, most finance/accounting functions are not fully consolidated in DFAS; for example, bill paying actions originate in the Services, are processed by DFAS, and are forwarded to DISA for further manipulation. To achieve the full benefits of outsourcing, DoD must work with the vendor to consolidate these fragmented processes.

**Training:** The Task Force believes that DoD institutional training is also a prime outsourcing target. Institutional training represents a \$14 billion annual investment involving about 138,000 military and civilian personnel. In particular, specialized skill training and professional development education appear ripe for outsourcing, since similar training programs are widely available in the private sector. In addition to cutting costs, outsourcing can play an important role in this area by stimulating broader use of innovative and cost-effective training technologies throughout the Department.



# Functional Area Recommendations: Defense Agencies/Activities

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- Initiate action in FY96 to outsource the following support functions:
  - Operation of commissary system at lower cost while preserving its benefits for military personnel (DeCA)
  - CONUS data and information processing services (DISA Megacenters)
  - CONUS accounting, payroll and other related major finance/accounting services (DFAS)
  - Transportation of household goods and other relocation services
  
- Expand efforts to outsource training and education
  - Outsource all “classroom” technical skills training
  - Focus on eliminating high cost military FTEs

### Function Area Recommendations: Defense Agencies/Activities (continued...)

**Health care:** Health care is a major DoD support service involving about 150,000 DoD military and civilian personnel and \$15 billion in annual operating costs. Of the 8.4 million eligible beneficiaries of the DoD health care system, 6.7 million are retirees or dependents of active duty personnel. In the view of the Task Force, there is little rationale for DoD to maintain organic health care capabilities to serve these populations. The civilian health care sector has both the capability and existing capacity to provide quality services to military retirees and dependents. Accordingly, the Task Force strongly recommends that DoD accelerate its efforts to shift an increasing portion of retiree/dependent health care to private service providers under the TRICARE program, which gives beneficiaries the opportunity to enroll in contractor-operated health maintenance organizations (HMOs). Moreover, the Task Force believes that DoD should act more aggressively to divest itself of organic health care infrastructure that does not directly support military readiness. This downsizing should be conducted in a way that preserves appropriate health care benefits for retiree and dependent populations at a reasonable cost to both the beneficiaries and DoD. Medical support functions that are found in abundance in the private sector -- such as optometry services, medical libraries, laboratories and testing services, equipment maintenance and pharmacies -- should be turned over to qualified service providers. DoD should also explore radical new approaches to increasing the role of the private sector in providing health care services to active duty personnel.

**Open DBOF suppliers to outside competition:** Finally, the Task Force recommends that DoD components be granted the flexibility to consider private sector bids for support services that traditionally have been provided by DoD support organizations on a cost-reimbursable basis. While the establishment of the Defense Business Operating Fund (DBOF) was intended to impose greater business discipline on support organizations, the monopoly position of DBOF activities tends to undermine this objective. Giving DBOF customers the opportunity to acquire support services from private vendors will incentivize DoD support activities to provide higher quality services at lower cost, and lead to the gradual privatization of support functions that cannot be performed efficiently by DoD organizations.

# Functional Area Recommendations: Defense Agencies/Activities (cont...)

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- Accelerate outsourcing of medical support functions
  - Fully implement TRICARE program
  - Outsource optometry, medical libraries, equipment maintenance, laboratories, pharmacies and other support
  - Explore new approaches to increasing private sector role in providing medical services to active duty personnel
  
- Allow Services to compete DBOF suppliers against commercial sources, ending the government monopoly in these support functions

## Functional Area Recommendations: Installation Support

The Task Force believes that, by transferring responsibility for most base support services to private contractors, DoD can achieve significant reductions in installation support costs while dramatically improving service quality. As noted on page 11, some 135,000 DOD personnel are engaged in commercial-type base support activities. In the view of the Task Force, private vendors could perform these base support functions with a fraction of the current manpower.

Although some base support services are already performed by outside vendors, these contracts generally are focused on narrow functions and involve relatively few workers. Mid-level base managers who supervise outsourced functions often have little incentive or authority to coordinate vendor activities across multiple functions. This installation support model results in inadequate executive-level visibility into support operations, excessive oversight costs, and little or no synergy between support functions.

The Task Force recommends that DoD adopt a new framework for installation support based on the positive private sector experience with integrated facility management (IFM). Under this approach, the operator consolidates all installation support functions into a single omnibus contract. The prime vendor performs all installation services with the support of a team of subcontractors. Such contracts usually include output-oriented performance incentives, providing the vendor with strong incentives to improve service delivery and reduce costs through the use of new technologies and more efficient business practices. The IFM model also allows base commanders to establish a single customer interface and a clear focal point of responsibility for base support services. With IFM, DoD can move toward the total elimination of the internal base support infrastructure for most installations.

**Base pilots:** The Task Force urges DoD to employ the integrated facility management approach for all military installations and facilities. However, because of the scale and complexity of base support requirements at many DoD installations, the Task Force recommends that each of the Services conduct pilot programs at two major bases prior to the across-the-board implementation of this outsourcing strategy. These pilots will provide valuable lessons regarding the most effective approach to structuring and managing an integrated facility management contract.

When developing these pilots, the Services should follow relevant Task Force recommendations outlined in earlier sections of this report. Streamlined, best-value competitions should be held for all installation support contracts. One IFM contract should be awarded to a single vendor (or vendor team) per site. The contract should include measurable, output-oriented performance incentives that reward service improvements and cost reduction. The period of performance should extend for at least five years, subject to cancellation for poor vendor performance.

**Military housing:** DoD's existing housing stock is clearly inadequate. Two thirds of DoD base housing is considered substandard, and its average age is 33 years. DoD estimates the cost of upgrading military housing at about \$30 billion. The private sector has extensive capabilities in the financing, design, construction, and management of affordable housing. DoD should utilize these capabilities to resolve the crisis in military housing. The Task Force recommends that DoD take full advantage of the authorities in the FY96 DoD Authorization Act to privatize military housing in Corpus Christi and other areas. DoD should gradually privatize all military housing and concurrently increase the housing allowances given to military personnel to help offset the financial burden of living on the economy.

# Functional Area Recommendations: Base Activities

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- ❑ Each Service should outsource **all support functions** at two or more **major** bases as pilots by the end of FY97
- ❑ These pilots should be performed under clear guidelines developed by OSD, including:
  - Single contractor per site, with subcontractor team
  - Best value competition, simplified RFP/contract
  - Output-oriented performance incentives
  - Cancellation clause for poor performance
  - Follow-on competition after five years
- ❑ Military housing in Corpus Christi and other areas should be privatized as pilots using new authorities provided in the FY96 DoD Authorization Act
  - Gradually privatize all military housing
  - Increase housing allowances, especially in high cost areas, to offset the fiscal impact on military personnel

### **Functional Area Recommendations: Other Outsourcing Candidates**

There is little rationale for DoD to maintain most of the internal organizations established to perform support services such as those identified in this slide. Private vendors can easily provide such services, usually at lower cost and with superior quality.

The Task Force therefore recommends that DoD initiate business case analyses on these and similar support functions to identify those services that could be transferred immediately to the private sector.

DoD should then make the top-down policy decision to reengineer its operations to “get out of the business” of performing such functions. If necessary, senior DoD officials should expedite the outsourcing process by waiving the requirement to perform formal A-76 public/private cost comparisons. The Department should also work closely with Congressional leaders to eliminate any statutory barriers to contracting out these functions.

**The Task Force urges DoD to employ this approach to outsource at least ten such support functions in the near future. This top-down initiative will serve to demonstrate the strong commitment of DoD leadership to fundamental changes in the way the Department acquires support services.**

# Functional Area Recommendations: Other Outsourcing Candidates

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- Based on business case analysis results, outsource ten or more of the following functions:
  - Printing services
  - Drug testing
  - Library services
  - Personnel support services
  - Security clearances/investigations
  - Software development/maintenance
  - Travel services
  - Environmental labs/testing
  - Classroom training
    - Weapons system maintenance
    - Individual skills
  - Dependent education
  - Housing
  - Data center operations
  - Payroll services
  - Civil engineering
  - Base-level supply/materiel mgmt
  - Primary pilot training
  - Airfield operations
  - Weather services
  - Buying/distributing bulk fuels
  - Transportation, including household shipments
- Senior DoD officials should exercise waiver authority to avoid formal A-76 cost comparisons

**Briefing Outline: Recommendations -- Proposed Early Actions**

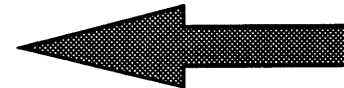
This section identifies those Task Force recommendations that the Department should implement immediately.



# Briefing Outline

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- Background
- The Challenge
- Private Sector Experience
- Public Sector Experience
- Primary Impediments
- Task Force Strategy
- Recommendations
  - DoD-Wide
  - Functional Areas
  - **Proposed Early Actions**



**Recommendations: Proposed Early Actions**

These recommendations are discussed on pages 51 to 60.

# Recommendations: Proposed Early Actions

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Establish key DOD-wide policies to stimulate outsourcing (SecDef/DepSecDef)

- Goal of \$7-12 billion increase in modernization by FY 2002, funded by outsourcing savings
- Clear DoD preference for outsourcing support functions
- Services to retain outsourcing savings for own use [DONE]
- Outsourcing targets & milestones for Components

- Establish Tiger Team to strengthen DoD'S service contracting capabilities (USD(A&T))
- Work closely with Congress to win passage of proposed legislative package to remove statutory barriers (ASD/LA)
  - Implement programs not constrained by law while awaiting legislative changes
- Deploy ABC at DoD activities targeted for public/private competitions to identify all government costs (Services)

**Recommendations: Proposed Early Actions (continued...)**

These recommendations are discussed on pages 61 to 63.

# Recommendations:

## Proposed Early Actions (continued...)

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- Initiate action to outsource the following common support functions (OSD):
  - Operation of the commissary system
  - Data and information processing services
  - Payroll & other major related finance/accounting functions
  - Support services at military hospitals in CONUS
  
- Implement outsourcing pilots by the end of FY97 (Services)
  - Two or more major bases per Service
  - Military housing in Corpus Christi and other areas

## Endnotes

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- <sup>3</sup> Deputy Secretary of Defense John White, Speech to Installation Commanders Conference, 30 January 1996.
- <sup>4</sup> Office of the Secretary of Defense, *DoD Manpower Requirements Report, FY95*.
- <sup>5</sup> Office of the Secretary of Defense, DoD Commercial Activities Inventory Data Base, FY94.
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- <sup>7</sup> Tracy W. Bernasconi, *Attendees of The Outsourcing Institute's 1995/96 Outsourcing Leadership Forums Provide an Excellent Insight into the Latest Trends in Outsourcing*, The Outsourcing Institute, April 1996.
- <sup>8</sup> The Outsourcing Institute, *Purchasing Dynamics, Expectations, and Outcomes*, 1995.
- <sup>9</sup> Arthur Andersen and The Economist Intelligence Unit, *New Directions in Finance: Strategic Outsourcing, 1995*. Study summary provided by The Outsourcing Institute.
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- <sup>12</sup> Hospitals & Health Network, 1995 annual survey. Study summary provided by The Outsourcing Institute.
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- <sup>17</sup> *Has the Outsourcing Wave Hit You?*, Training and Development, November 1995.
- <sup>18</sup> Gartner Group, *Research Note*, April 10, 1995.
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- <sup>21</sup> The Outsourcing Institute, *Purchasing Dynamics, Expectations and Outcomes*, 1995; page 5.
- <sup>22</sup> David Osborne and Ted Gaebler, *Reinventing Government: How the Entrepreneurial Spirit is Transforming the Public Sector*, Addison-Wesley Publishing, Co., Inc., 1992.
- <sup>23</sup> Logistics Management Institute, *Outsourcing DoD Education and Training: The Application of Private Sector Experience* (symposium paper), 1 November 1995.
- <sup>24</sup> Frank Camm, *Expanding Private Production of Defense Services: An Annotated Briefing* (PM-480-CRMAF), RAND, October 1995.

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- 25 Carla Tighe, Sam Kleinman, Jim Jondrow, Derek Trunkey, *Outsourcing and Competition: Tools to Increase Efficiency* (briefing), Center for Naval Analyses, January 1995.
- 26 Alan J. Marcus, *Analysis of the Navy's Commercial Activities Program* (CRM 92-226.10) Center for Naval Analysis, July 1993.
- 27 Deputy Secretary of Defense John White, Speech to Installation Commanders Conference, 30 January 1996.
- 28 Office of Management and Budget Circular Number A-76, *Performance of Commercial Activities* (Revised Supplemental Handbook), March 1996.
- 29 Ibid., Chapter 1, Section E.
- 30 Ibid., Chapter 1, Section C.
- 31 For an assessment of accounting systems/internal controls in government maintenance depots, see Coopers & Lybrand, L.L.P., *Depot Maintenance Public vs. Private Competition*, March 1995.
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- 33 Coopers & Lybrand, L.L.P., *Strategy Options for Defense Information Services*, December 1995.

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APPENDIX A

TERMS OF REFERENCE



ACQUISITION AND  
TECHNOLOGY

THE UNDER SECRETARY OF DEFENSE  
3010 DEFENSE PENTAGON  
WASHINGTON, D.C. 20301-3010



OCT 18 1995

## MEMORANDUM FOR CHAIRMAN, DEFENSE SCIENCE BOARD

SUBJECT: Terms of Reference-Defense Science Board Task Force on Privatization and Outsourcing

You are requested to form a Defense Science Board Task Force on Privatization and Outsourcing as a strategy to effect cost savings, quality improvements, and increased efficiencies for DoD activities while releasing financial and human resources for readiness and modernization. Work should begin as soon as possible, with the Task Force providing an interim report by February 1, 1996 and a final report by May 1, 1996.

The Task Force shall address the following issues related to outsourcing and privatization:

1. In the last 40 years, an active private sector has developed that has the capability to perform many DoD functions now exclusively performed by DoD. What activities is DoD currently doing that could be performed by the private sector with greater efficiency, at lower cost, with higher quality? What DoD functions should receive priority attention? A broad range of DoD functions should be considered including, but not limited to, depot maintenance, materiel management, housing, base commercial activities, education and training, finance and accounting, and data centers.
2. Based on private sector experience, what levels of savings can be expected? How long will it take for savings to be realized and what, if any, up front costs or investment will be required?
3. It is likely that there will be tensions between political imperatives driving the government and financial considerations driving the private sector. Since the specifics of DoD's privatization plans will impact the chances for success, what terms and conditions will encourage or discourage commercial entities from competing for opportunities?
4. What process should DoD follow to carry out an effective privatization and outsourcing program? What lessons can be drawn from the private sector experience about implementing an outsourcing plan? What personnel, accounting, or other organizational implications for implementing privatization should DoD take into consideration?



5. What specific actions should DoD take over the next year to accelerate the shift to privatization and outsourcing? The Task Force will provide a plan with specific recommended actions and time tables.

In addition to assessing experience in the commercial world, the Task Force will examine other public sector models, including experience in the UK (shipyard and depot privatizing) and US state and local government (various outsourcing actions). The Task Force will portray the totality of the value of privatization and outsourcing to the DoD.

This Task Force will be sponsored by the Assistant Secretary of Defense for Economic Security (ASD-ES) Josh Gotbaum. Mr. Philip A. Odeen will serve as the Chairman of the Task Force. Ms. Julia Vindasius, White House Fellow assigned to the Office of the Secretary of Defense (OSD) will serve as the Executive Secretary. Major(P) T. Van Horn, USA, will serve as the Defense Science Board Secretariat representative.

This Task Force will be operated in accordance with the provisions of P.L. 92-463, the "Federal Advisory Committee Act," and DoD Directive 5105.4, the "DoD Federal Advisory Committee Management Program." It is not anticipated that this Task Force will need to go into any "particular matters" within the meaning of Section 208 of Title 18, U.S. Code, nor will it cause any member to be placed in the position of acting as a procurement official.

*Paul G. Kaminski*

Paul G. Kaminski



APPENDIX B

TASK FORCE MEMBERSHIP

MEMBERSHIP LIST

DEFENSE SCIENCE BOARD TASK FORCE ON  
PRIVATIZATION AND OUTSOURCING

Chairman

Mr. Philip **Odeen\***  
BDM International, Inc.

Task Force Members

Mr. David **Berteau** @  
SAIC

Mr. Ed **Biggers** \*  
Private Consultant

Mr. Dennis **Bovin**@  
Bear Stems, Inc.

Gen Mike **Cams**, USAF (Ret) @  
Private Consultant

Mr. Jim **DeFrancia**@  
Lowe Enterprises

Mr. Bob **Dickhaus**@  
Johnson Controls, Inc.

Mr. Dan **DiMaggio**@  
UPS

LTG William **Forster**, USA (Ret) @  
Westinghouse Electronics Group

Dr. Bob **Kaplan** @  
Harvard Business School

Mr. Joe **Kasputys** @  
Primark

Mr. Jerry **King** \*  
Boeing Defense & Space Group

Mr. Mort **Meyerson** @  
Perot Systems

LTG John **Moellering**, USA (Ret) #  
UNC Aviation Services

Mr. Robert **Murray** @  
Center for Naval Analyses

RADM Dave **Oliver**, USN (Ret) @  
Westinghouse Electric Systems

Mr. Bryan **Rowe**@  
General Electric

GEN Crosby **Saint**, USA (Ret) @  
MPR, Inc.

Mr. Larry **Seifert**@  
AT&T

Mr. John **Stewart** #  
McKinsey & Co., Inc.

Gen Larry **Welch**, USAF (Ret) \*  
IDA

Mr. Tom **Willardson**@  
Bechtel Enterprises

Mr. Tom **Young** #  
Private Consultant

\* DSB Member

# Approved DSB Consultant

@ Pending approval as DSB Consultant

Executive Secretary  
Ms. Julia Vindasius  
White House Fellow  
OSD

DSB Secretariat Representative  
MAJ(P) T. Van Horn  
USA, Military Assistant

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DSB Reviewers  
Dr. Jacques Gander  
TASC, Inc

Mr. Robert Parker  
Private Consultant

Paul J. Kaminski  
USD(A&T) Approval **NOV 30 1995**

Shelia B. Helton  
SASD Coordination