Speech to the Defense Manufacturing Conference

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It's a pleasure to join you this morning. I apologize for the fact that you're listening to my disembodied voice coming in through the speakers and staring at my mug shot. I don't envy you at all that you're doing that.

I had hoped to be there in person, but a couple of things intervened. One is of course our budget situation, which is coming to something of an endgame here as we're trying to put our budget together and a number of important decisions are being made. I need to be here for that. And also the logistics piece of the acquisition, technology, and logistics title came into a little more prominence with the events this weekend and the closing of the ground lines of communication in Pakistan.

But I did want to at least address you in whatever form. And I'll echo Brett's comments about how good our security is, but it's unfortunate I couldn't at least be with you by VTC with a full link. With that in mind, let me see if I can make this somewhat interesting. However, you have the opportunity to go get coffee, and I'll never know. So maybe there's an advantage on your end as well.

We live in interesting times. And the future of Defense manufacturing is an important, a critical aspect of the future of the Defense Department. So it's a timely conference, and looking through your agenda, I think you have a great range of speakers. You have people from other parts of the Administration, a number of people from the Defense acquisition establishment, as well as from industry itself, and from some of the nonprofits that are associated with our field. I'm going to try to set the stage a little bit for that, and I know you have a lot of details to get into later on during the two days.

I know first of all that one of the things most on your mind right now is a very fundamental question that you don't know the answer to. And the question is: what's our budget for Defense going to be? We've been thrown into a somewhat of an uncertain period because of the failure of the supercommittee. So I'm going to look back to one of my favorite movies, actually, to try to give you sort of an answer to that question.

The movie is an obscure movie from about 20 years ago called "Captain Ron." Captain Ron is a character played by Kurt Russell, I think, in the movie who is somewhat of a reprobate charter skipper for hire in the Caribbean. And Martin Short in the movie plays a Chicago businessman who inherits a decrepit sailing vessel, old yacht, and decides to take his family to the Caribbean to get this yacht and sail it to Florida. So they go down there and they have hired Captain Ron. And the first day they're together, they go onto the boat, they go down into the engine room, and Captain Ron is there with Martin Short. Captain Ron starts to put oil into this rusty old-looking diesel engine in the boat, and he says to Martin Short, "You know these old diesels, they sure like their oil." Martin Short looks at him and says, "Why is that, Captain Ron?" And the answer is, "Nobody knows."

Well, the answer right now about what our budget's going to be is, "nobody knows."

The failure of the sequester – of the supercommittee, has put us into a period of tremendous uncertainty. What we tried to do with the supercommittee, what was attempted I believe, was to essentially put some element of the Congress, a bipartisan committee, into a locked room with a ticking time bomb, and to give it a task to perform before the bomb went off. Well what turned out was the door of the room wasn't locked, and there was a pretty long fuse on that time bomb. So the supercommittee was able to get out of the room and leave that bomb ticking away. Well the bomb is still ticking, but the supercommittee along with the rest of the members of Congress are still in the building where that room is; it's called the U.S. Congress. And they still have a job to do.

So basically we don't know how this will all come out. But sequestration is an unacceptable outcome, as devastating an outcome today as it was before the supercommittee was unable to reach agreement. And our expectation and our hope is that Congress will deal with that problem in the time that it has available. So those who have asked us what are we planning for – what we are planning for right now, and the budget we intend to submit at the end of January, early February, is a budget that's consistent with a level of cuts we were asked to take in August. And that is about $490 billion spread out over the next 10 years. That is a pretty severe cut to take already, and we are going through a process of preparing a budget based on that.

Now Secretary Panetta has been very articulate about the impact of sequestration. It's not just the additional $500 odd billion dollars that we would have to take; it's also the way that those cuts would impact us. Now while Congress does have some time to act, it's not infinite. We're not planning for sequestration currently, but if too many months go by and Congress does not act, we will have to start taking some measures to prepare ourselves for that possibility. But at the moment we think, we hope that that will not be necessary.

When we expose our budget in a few months with the levels of cuts that we're already taking, we expect that that will be pretty strong evidence of the severity of the cuts that we're already taking, and hopefully will be an added impetus to the Congress to act. But we will see. As I said, at the moment, nobody knows.

So we are in a period of uncertainty. The last time I lived through a period somewhat like this was at the end of the Cold War. At that time, I was in the Pentagon working in acquisition responsible for tactical warfare programs. There's a major difference between this period and that period. At the end of the Cold War, there was a dramatic change in the threat that we confronted. The security situation fundamentally changed in the world with the demise of the Soviet Union. That's not the world we're living in today. The security situation we see is roughly the same. In fact, in some areas, it may be getting worse. We are still faced with a terrorism threat. We are faced with potentially rogue states that could be problematic. And we are faced with rising competitors in the world who are modernizing their forces.

So in that environment, we are going to be taking significant cuts. And we are doing it basically because of the deficit situation. Now we think that at the level that I described, the $490 billion level over 10 years, we can still preserve the essential elements of the national security strategy that's in place today. We are going to have to revise our guidance, and we're in the process of doing that. So the first step in considering that level of cuts, to say nothing of the sequestration level, is to take a look at our strategic guidance and see what makes sense there. That discussion's been going on here in the Pentagon for the last several weeks. It's taking place under some guidance from the Secretary, and I'll reiterate that to you. He's articulated this in different formats.

But basically, we have to maintain our dominance. We have a technologically superior force. We have a well-trained force. We have a force that is the best in the world. And it is capable of doing a wide variety of missions. And as we go forward, we want to maintain that dominance in order to preserve our national security. That's sort of an essential element of what we are and who we are as a country.

The force must also be ready, agile, deployable, and capable. It can't be a paper force. Another way to say that is we don't want to have a hollow force. Now I was an operator in Europe in the 70s, and I lived through the era where we had a readiness crisis essentially, where we did not put adequate resources to operating and support accounts. And as a result, my unit, which was a Hawk air defense battery at the time, had serious shortfalls in spare parts, and was non-operational a large part of the time. This is when we were supposed to be guarding the border with—the central intra-German border. We don't want to go back to that. That's one of the ways we could go to a hollow force, through lack of materials for maintenance. Another way is through training, and cutting back on training. Another way is if we don't modernize adequately. So there are a number of ways we could go off course, and we don't want to do that. We want to have a capable force.

We're going to continue to emphasize efficiencies. The things that Secretary Gates started, including the Better Buying Power Initiative that Dr. Carter and I started in acquisition, and the number of other things, we will continue to emphasize and we will search for efficiencies. And everything is on the table in that quest. But at the end of the day, there is only so much we can do there. Eventually we have to do things that cut the actual content in terms of what we have.

The last item is that we have to keep faith with our people. And we've been a nation at war for 10 years. And we have people who have been deployed repeatedly, who have given everything that they can be called upon to give. They and their families have sacrificed a great deal for our country. And we want to keep faith with those people.

So those are the sort of guiding principles as we try to put together a budget that meets the guidance we already have. Essentially, we will maintain a force within guidance which does almost everything we set out to do under the Quadrennial Defense Review. This is not a change to our fundamental strategy at this point in time; it's a change in the details of that guidance and how we implement it. That comes first. We're roughly through with that process.

In parallel to that, and continuing for the next couple of weeks, we'll be trying to put our budget together, and make sure it's consistent with that guidance. So that's what we're about now. It is a difficult task, and as we go through this, everything is on the table. Okay, we are looking at things now as we look at cuts we have to take that cut across the areas of the Department where we would traditionally not have gone to find money, but we have to do that now. That's the context in which we are building our budget. We think we will have a sound budget that meets those goals that I described, that is consistent with our strategic intent. But it's not going to be easy to do, and there are going to be some painful choices that have to be made to get there.

Let me turn a little bit now to my perspective from where I sit overseeing acquisition, technology, and logistics. And talk a little bit about my priorities there as we go through what's going to be a difficult period over the next few years. There's not much here in terms of fundamental change. I made a speech about a year and a half ago where I said much the same thing. And this is very consistent with what Dr. Carter was doing. One thing you will get because of the way we have shifted positions here in the Department is some continuity, which I think provides some stability and something you can count on in how we go forward.

But number one of course is support to the wars. We are still at war. We will, in a matter of weeks, be out of Iraq, but we have a ways to go in Afghanistan. And as I had alluded to earlier, we have to provide the logistics support there, we have to provide the rapid reaction support to meet the needs of the Commanders there. We have to sustain that force and give it the equipment it needs to fight. So that's number one.

The next thing on my list is affordability. One of the things we're going to have to do in the environment we're entering into is ensure that we start only those programs which we can actually afford. If you look back over the cancellations and terminations of programs that have happened over the past few years, what runs through them very consistently is the fact that many of those programs were never affordable. But we started them. We invested in research and development. In some cases, we started production. And then we made the realization that we actually could not afford those programs in the types of quantities we wanted. And we had to cancel them. We don't want to waste funds that way. We want to start programs that we actually can afford. So we are imposing constraints on our programs, on our new starts, to ensure that they're affordable.

Next thing is efficiency, which I mentioned earlier. This is essentially the heart of the Better Buying Power initiatives. And that is more a process than a specific set of initiatives. We will continue to search for ways to increase our buying power as well as implement the initiatives that Dr. Carter and I started about a year ago.

The next thing on my list is the industrial base, which is obviously key to the conference that you're having. We have to have a strong industrial base. And I will say much more about that in a few moments.

Next thing on my list is the work force, and strengthening our own workforce. In order to be effective at all the things that I've talked about, our own workforce in government has got to be as capable, as effective as it possibly can be. We've had some growth in our workforce. We hope to have a little bit more of that, but we're going to turn our attention increasingly toward making that workforce more productive and better at doing the things it has to do to get the most out of ourselves and out of industry.

The last thing on my list is an item that would not have been on it a year and a half ago – was not on it. And that is we have to protect the future. The Defense budget environment is cyclical, and we are entering into a downturn. It won't stay a downturn forever. But as we go into this, we have to be very mindful of the things we need to do to ensure we have all those capabilities that I described, and that the Secretary is asking us to preserve as we go into the future. That's a combination of science and technology investments. It also includes making sure that we don't do damage to the industrial base. It includes preserving some capabilities that we've created, and may need in the future, like contingency contracting capabilities. So as we go through this period, we need to be very careful about how we take whatever cuts we end up taking to ensure that we protect the future.

A number of things that contribute to all of those – we have to have better use of competition. We're going to use tools out of Better Buying Power like "should cost." And we need to provide strong incentives to industry to perform well and ensure that we enforce them. So those kind of cut across all of those things.

Let me turn now to the industrial base. The industrial base is our partner in the Defense enterprise. We're in this together, and we're in it for the long haul. We can't do what we do in government without you, and obviously you're dependent on us for your existence. There's a mutual dependency there. And we do understand industry's importance. The way I would phrase this, and perhaps this is perhaps my first kind of foot-stomper for this talk, is that the Defense industrial base is part of the country's defense force structure. Now, that's very evident right now in terms of the contractors who are supporting us overseas. Roughly half of the people we have deployed to Iraq and Afghanistan have been contractors. That's half our force structure, in effect, in those countries. Now we didn't anticipate this. Several years ago when we got into these conflicts, we did not anticipate that we would deploying a large force of contractors as part of the total force. But we did. And we had to learn how to manage that force, and how to use it effectively, how to avoid waste in that environment, how to develop the skill sets necessary to do that. And we've done so. We've made enormous progress in that area.

I think the same thing is true when we look at the Defense enterprise writ large, and we look at how the industrial base contributes to the equipment that basically supports – and the Services – that support our force structure. So the bottom line there is that we have to take very seriously the impact of our budget choices on the industrial base. And we are doing that.

Let's talk about the strategy for dealing with the adjustments that we're going to face over the next few years, and what we're going to do there. There's been some discussion in industry that we needed a more thoroughly articulated strategy. I'm not sure exactly what the intent behind that has been, but basically we're not going to pick individual winners and losers and say exactly how many companies are going to be preserved in a given commodity area for example. But we are going to try to ensure that we get through this successfully together, and come out with a strengthened industrial base rather than a weakened one at the end. It may be smaller, but we hope it'll be stronger.

That means basically, and I'm going to borrow a little bit from Dr. Carter – again, this is an area where we have some continuity – Dr. Carter spoke at the Cowan Investment Group several months ago, and some of this essentially mirrors what he said – and I'm going to amplify a little bit on some of the things he said then.

The goal of course is a strong, vibrant, and financially sound Defense industry base. That's always our goal.

We are going to first of all – the first element is to allow structural change to be driven largely by market forces. We think frankly at the end of the day industry people, industry managers, CEOs, who plan for the future of their companies, are best positioned to figure out the best way to adopt to the markets we're going to be into – a downturn in the markets. It's a new environment. We haven't seen this for about 10 years. And it's going to be some pain associated with this. But we believe that market forces are the best way for people to adopt to the changes.

We are going to discourage consolidation at the top tier. That's the second element. At the end of the Cold War, there was a lot of consolidation that was occurring at the top tier. I was part of that first of all in government and later on in industry. So I understand what happened there. And we came to a point where we said, "Okay, we think this is about enough." The government came to a point where it said it thought this was about enough. And that was where it would stop. That was sort of an abrupt stop. People didn't quite anticipate it at the time. We think that today, we're there – that at the top tier, we have about the right level of consolidation. We want to preserve competition at that tier as much as we can. And even with the cuts we envision, there's still a large market that we think supports that level of consolidation.

We will, however, intervene selectively at tiers below the top tier to preserve competition and to protect critical capabilities. So that's the third element. Now selectively means rarely. Okay, when we intervene, it usually means there's a cost associated with that. And we have to do a lot of tradeoffs right now in our budget among a lot of things that we would like to buy and can't. We're going to try to intervene rarely where it's really needed, where it's critical to provide some continued competition, where that's in the interest of the Department, an whether this capability is a key capability that we have to preserve. Again that's going to be selective.

The fourth element is that we want to be proactive about understanding and taking into account impacts of our decisions on industry. We want to be as ahead of the power curve as we can. And there are a number of things that we're doing to make that happen. The Secretary himself has opened up a dialogue with industry. He's had meetings with some of the lead industry associations. With a little bit of encouragement from the Defense department, AIA –Aerospace Industries Association, the National Defense Industries Association, and the Professional Service Council – got them together to form a task force on their own to provide some input to the Secretary and to the Department about how this will affect them, and to give us some ideas about how they see this playing out and how its effect on industry will impact. So that's another thing that's being done.

Another thing that I know Brett will talk about at length is his work on the Sector by Sector and Tier by Tier analysis. We are trying to build a detailed understanding of the Defense industrial base across all the sectors and through each of the tiers from the top down to component suppliers. A lot of our problems that we anticipate as we go through this period, and in some case reduce some of our production levels is going to be at tiers where there are components and subsystem suppliers who won't have an adequate business base. That's something we have to understand and we'd like to be ahead of that curve again and see those coming, rather than be reactive.

We also will work with individual companies, and the door is open for companies to come in and inform us of problems that they see. And we will be working with the individual associations or nonprofits as we go forward. The single best way for us to find out about problems is probably when industry tells us about them. You're watching all this and paying attention to it as well. And you're much closer to the problems in many cases than we are. So for industry to come forward is another, and perhaps I think as I said, the best way.

We are particularly interested in the lower tiers. 70% roughly of our costs for our products goes to suppliers at the lower tiers. So that's where a lot of the money is. It's where a lot of the effort actually is.

Another item of particular interest for me is design teams and this reflects my engineering background. I think that the design teams that we support for the major commodities are fragile, and once they go away, it's very, very hard to replace them. There's a body of knowledge in those design teams that it takes decades to build up, and once lost, it will take at least years to reconstitute. So I'm concerned about preserving our design teams.

The next element, the final element, the fifth element is we want to be as transparent and responsive as possible about the government's intentions. One of the things that Norm Augustine, whom I think is a name you all will recognize, mentioned to me not too long ago was that he was at Lockheed Martin at the time that the consolidation at the top tier of the industry ended. It ended relatively abruptly. And it ended with mixed signals from the government, which were very disconcerting and disruptive to industry at the time. So we hope to be as transparent as possible about our intentions, and about what steps we're willing to take or not willing to take.

And I want to emphasize as I close on this list is that intervention again is going to be rare. It's a question of resources, frankly. We can't preserve every capability that we'd like to preserve any more than we could preserve every element of our force structure or every one of our weapons programs. So we're going to intervene on rare cases where we feel it's important for us to do so, but again it will be rare.

I want to turn now to some of the terms of our partnership, and our desire to see industry do well and at the same time for our desire in government to drive costs down. These can be in conflict. And I want to talk about how we try to reconcile that conflict moving forward. And there has been I think some reaction to Better Buying Power, at least initially, that reflects a misunderstanding of our intent. And I don't want to miss any opportunity, particularly when I'm talking to industry, to be as clear as I can about that intent.

And I'm going to start with the big one, which is profit policy. There has never been an intent by this Administration or by Dr. Carter or myself or any of the other senior leadership in acquisition to go after profit as a way to reduce costs. Profit's a relatively small element of cost. We would like to use profit as a tool to incentivize people to perform better and to reduce our costs by better more efficient performance. It's a very different thing.

What we want to do is to use profit to align industry's interest and government's interest in what I would call "win-win business deals." So I think the second foot-stomper for this morning is that what we're after is win-win business deals. And we're trying to negotiate deals that do a good job of getting value for the government but also provide a reasonable return for industry. And if industry does very well, provide industry with a much higher profit margin than they would get otherwise. So that's what we're after: win-win business deals.

Healthy does mean profitable. When I talk about a healthy industrial base, I want to say that it also means a lean industrial base. And as we go through a period with declining budgets, it's really important that industry do its share in driving out unnecessary costs. I think to be competitive you're going to need to do that. To get those higher margins that I talked about, we're going to ask you to do that and try to provide incentives to you to do that.

Another subject that I want to mention briefly because it's come up a lot, and partly because there's initiative to move more in this direction on the Hill right now, is fixed price contracting. My own background includes living through the years of straightening up a lot of programs that got into trouble because we thought for a while that fixed price development was the solution to all of our cost overrun problems. That didn't turn out to be the case. In fact, that assumption turned out to be something of a disaster.

So I spent a few years in the early 90s trying to clean up the messes that were fixed price development contracts that included the A-12 and some others. So I am not a fan of transferring excessive risk to industry through contract vehicles. That doesn't work. What we have tried to do with Better Buying Power is to shift somewhat for the earlier rounds of production in particular, to a fixed price incentive fee arrangement.

And by the way, I make these comments to government, as much as I make them to industry because there is a tendency sometimes on the government side to overreact to our guidance.

But basically what we are trying to do with our contracting strategy is to use the range of contract types that are available where they're appropriate. So that does mean a shift on the margins to more fixed price incentive fee contracting particularly in early production – once you've got firm requirements, once the risk is out of the program, and once contractors can bid with some confidence in their pricing. So that's the intent there.

Contracting vehicles are not a panacea. They do not make people better engineers or better industrial planners. So we need to be cautious about how we do that. I bring it up in part because there's a movement on the Hill to move more in that direction than we're comfortable with, and we're resisting that.

I like to cite the tanker program as an example of where fixed price contracting even for development does make sense. It's not a unique program, but it's not a program or situation that you see commonly either. In the tanker situation, what we had was, first of all, very firm requirements. We had technology second of all that was mature. We had people who were bidding who knew how to do this type of a job, had good experience in the area of the commodity we're trying to buy. We had people who had the resources that if they did get into trouble in development, they could bail themselves out. And we had a situation where the business case for them to do that was strong.

So when you put those five elements together, you had a good case for fixed price development. If we don't have those five elements, I think we'd have to look very, very carefully at that. Even in production, early on, we have to look at the level of risk. And in some cases in early production, cost plus will still be the right type of vehicle. But as we get further into production and move towards what ultimately and I think in almost every case will be firm fixed price contracting, there is a window in there where fixed price incentive fee makes sense. And we are underutilizing that vehicle, which is the reason for the shift in Better Buying Power.

Okay, I'm going to turn now, finally, to the subject which is going to dominate your conference, I think, and that's Manufacturing Technology and our program there. Brett and his office have taken over the oversight of this program. It's been a tremendously successful program, and I noticed that the conference has been talking about this subject for 50 years now, which is a tremendous record. I think the longevity of the program is a testimony to its success.

We're in a situation right now for ManTech as well as for every other investment, and I mentioned a couple earlier, where our problem is similar to the problem that many businesses face. We do not have a shortage of good ideas to invest in – things with high return. What we have is a shortage of capital. So we're going to have to be prudent in our investments. We're going to have to screen things more carefully. But we definitely want to continue this program and make it as strong as we can afford to make it.

The program has gotten savings for us on the order of a 10:1 payoff on the average. And that's a pretty good return for any investment. So I think we will have some very strong programs here. Brett has jumped into this, you know, with great enthusiasm that he shows for everything that he does, and I expect we will continue to see successes. But we will probably have to be more selective.

There are a lot of examples of successes. I won't go through those now. I noticed that Lieutenant General Wolfenbarger is going to discuss some with you later on when she speaks. And there are other examples I think that you've been listening to. I was listening to the videotape earlier where some were highlighted.

I started out – I'm going to wrap up now, give you a chance to ask me a few questions – but I started out talking about something that I didn't know and the fact that nobody knows. Let me end on a note on some of the things that I do know.

First of all, I know that we will get through this period together. It's going to be a bumpy ride, but we're going to weather this. We still have large investments that we're going to be making in Defense even though they're coming down. And it's not the kind of climate that we've been used to for the last few years. But there's still plenty of business to pursue out there. We'll get through this.

I also know that there will come a time when our security situation demands an upswing in our Defense spending and that markets for Defense will improve. If you look at the history of our Defense budgets, that's the entire history of our Defense budgets. And as I mentioned earlier, the national security situation is not changing this time; it's staying roughly the same and perhaps getting worse over time, at least in some areas, even as we get out of Afghanistan and Iraq.

And finally, I want to say that we can work together and we can all come out of this stronger and more ready to support our Warfighters. We can do that if we work together to understand and address our mutual problems.

And on that note, I'm going to close – take some questions. I look forward to working with you to achieve that goal. And I thank you for your attention, despite the difficulties that we had to do this. And I want to thank you for all that you do for our country.