



ACQUISITION,
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The Defense Industry Enters a New Era

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Beginning in May of last year at his speech at the Eisenhower Library, Secretary of Defense Gates has been signaling loudly and clearly that we are entering a new era in defense. President Obama's planned defense budgets are robust and strong, and will stay so. We are, after all, involved in two conflicts and several smaller ones, and the world is dangerous. But we won't have the ever-increasing defense budgets of the past decade and need to be attentive to the nation's other needs. In Deputy Secretary of Defense Lynn's words, we are at an historical inflection point but one that can be different if managed proactively.

Secretary Gates launched a many-pronged Efficiency Initiative to ensure the Department is managing the budget in a manner that is, as he put it, "respectful of the taxpayer at a time of economic and fiscal distress." As one of those prongs, he tasked me, the Acquisition Executive, to devise a plan for the \$400 billion out of the approximately \$700 billion base-plus-wartime budget that is contracted out. This led to BETTER BUYING POWER, introduced by Secretary Gates and me on September 14, 2010. It is guidance from me to the acquisition workforce in the Defense Department on how we can get "MORE WITHOUT MORE."

In the past two years, we've cancelled many programs that were not performing, whose time had passed, or where we had already bought enough – altogether, more than \$300 billion worth. But most of the programs we now have underway or which are getting underway are military capabilities we *do* need and *do* want. We need to get them for the money the country can afford to give us.

BETTER BUYING POWER is summarized in the chart that has been passed out to you. Its twenty-three points were devised with input from the DOD acquisition workforce and from our partners in industry. We are now implementing each and every one of them. In the accompanying letter, which you also have, I provided – for each of the twenty-three points – my specific intent, the metric of success, and a specific example. The twenty-three points cover ways the government can improve its own performance and incentivize better performance in our industry.

I'm happy to take questions on any one of the twenty-three points, but for my remarks let me turn to a different but closely related subject.

As we in the Department adjust our programs and buying practices to the new era, our industry will also be making adjustments. During my last tour in DOD, I attended the so-called Last

Supper at which the DOD leadership and industry leadership discussed the adjustments industry was making to the end of the Cold War and to the military technological revolution that had then just recently been illustrated by our victory in the first Gulf War. The Last Supper has been immortalized by the legendary industry leader Norm Augustine of Lockheed Martin. In the course of the dinner, Norm turned to his neighbors on his right and left and told them, “Next year only one of you will be here.”

That was a very different circumstance from today. The defense industry of that era was also very different from today’s industry. But though the circumstances are not comparable, now – as then – a dialogue between industry and DOD about the future of our industry is needed to chart a course together. Secretary of Defense Gates, Deputy Secretary Lynn, and I have made it our practice to meet frequently with defense industry leaders, reversing an unfortunate trend in recent years. Today, let me begin a dialogue on this subject of industry adjustment to the new era by suggesting a few guideposts we will be following on the government side.

The fundamental starting point is the understanding that we in DOD do not make our weapons systems. They come from our defense industry. And these weapons systems are, second only to our superb men and women in uniform, what makes our military power unrivaled and what provides the buttress of national and international security. A strong, technologically vibrant, and financially successful defense industry is therefore in the national interest. In this respect the warfighter’s and taxpayer’s interests are fundamentally aligned with those of the industry shareholders – who I know are the focus of this audience.

Next, the government’s interest is not short-term, but long-term, like those of long-term investors. We will promote policies and actions that provide for long-term innovation, efficiency, profitability, and productivity growth.

With this as background, let me suggest seven guideposts we will follow in considering our industrial structure in the era we are entering.

First, in the main we will rely on normal market forces to make the most efficient adjustments to the defense industrial base. This is not only in accordance with good economic theory, but necessary to prevent the defense industry from becoming further distanced from the main currents of 21st century technology, creativity, and capital markets. These forces will doubtless lead to an uptick in the volume of M&A and other industry adjustments in the coming period, and this is normal. For our part, the Defense Department welcomes needed adjustments that lead to greater overall efficiency but will require transparency with respect to all contemplated transactions. We will examine these transactions to ensure that the Department’s long-term interests in a robust and competitive industrial base dominate any near-term or one-time proposed savings, that potential organizational conflicts of interest are avoided or carefully mitigated, and that we have full visibility into restructuring costs and the potential for continuing capital investment and R&D. The interests of the taxpayer and the warfighter will be forefront in our minds as we review proposals that may result in the creation of weaker stand-alone firms less likely to thrive without the necessary capital structure that their larger parent company is able to provide. In such cases transparency will be essential so that we are confident the value created largely by the Department over the years is not lost to the detriment of the taxpayer or the

warfighter. The Defense Department would not want to see its industrial base experience what has happened in some other sectors of the economy: poor risk management, unnecessary leverage, and excessively short-term behavior at the expense of long-term health. Transparency allows all these things to be addressed early in the process, which is in the interest of all involved.

Second, as President Obama made clear to all Federal departments and agencies when he took office and most recently last month in Schenectady, NY, competition is one of the key drivers of productivity and value in all sectors of the economy, including defense. Accordingly, the Department is not likely to support further consolidation of our principal weapons systems prime contractors. A number of our specific Better Buying Power initiatives are aimed at increasing competition among all our suppliers and throughout our procurement of goods and services. Sometimes competition is provided by having two or more providers of the same thing go head-to-head, but where this is not possible we can still harness this power through a wide variety of other competitive strategies that provide real incentives for increased productivity. Where program costs can be reduced, government and industry can share the savings, which will be directly reflected in earnings and profit.

Third, we will be looking at our industry sector by sector – from shipbuilding to professional services, and from stealth to space – because the dynamics are different in each sector. Deputy Secretary Lynn has directed a comprehensive sectoral study of our industry, which is being led by Brett Lambert. This will not be a one-time snapshot, but rather an ongoing guide to us as we seek to sustain the health, vibrancy, and efficiency of the industrial base upon which our security depends. While we cannot sustain the base in a given sector if it has the wrong size and shape for the new era, once it is right-sized and right-shaped, the government will take an interest in keeping it that way.

Fourth, our interest in the defense industrial base extends throughout its entire spectrum. Far too often, people view our industrial base as being made up of those who receive prime awards. The truth is that perhaps two-thirds to three-quarters of every dollar we award at the prime level is spent for subcontracted goods and services at the so-called “lower tier” of the industry. But while these companies might be “lower tier” in this sense, they are not of lower importance – they are centrally important to a healthy industrial base. They are frequently rich in technology and dynamism. They are also important drivers of program cost – frequently down but sometimes up – and the sources of supply chain efficiencies or, alternatively, disruptions in major programs. So their health and performance are critical to us. Smaller firms, start-ups, and new entrants provide needed new technology, new faces, and new ideas to the defense industry. The nation’s small businesses add vitality to our base in both prime and subcontractor roles. Mid-sized companies are especially important and worthy of fostering, as they can grow into new sources of innovation and competition.

Fifth, the Better Buying Power Guidelines give heightened attention to the increasing importance of the “services” component of the “goods and services” we require – again provided by firms not often considered “defense companies.” These services are as essential as weapons systems to mission accomplishment, and Better Buying Power directs a number of steps to better understand and manage this part of the Department’s spend. Currently about half of our prime

contract spending is in the services sector – and this does not take into account the portion of services required by traditional procurement programs. The “services” portion of the industrial base is correspondingly growing and changing. Some of the companies that provide these needed services have grown quite large and take an important place in our industrial landscape alongside the more familiar brand names. Others are innovative small businesses. As we improve our approach to services procurement, we will be attentive to its industry foundation.

Sixth, a key part of our defense industrial strategy is to encourage new entrants. These offer competition, renew and refresh the technology base, and ensure that defense is benefitting from the main currents of emerging technology. We must accordingly work constantly to lower the barriers to entry. We are addressing many of these barriers – such as needless or time-consuming paperwork – as part of the Better Buying Power initiative because they impose unnecessary costs. But another objective of eliminating non-productive processes is to make it easier for companies to do business with us. We continue to seek industry feedback and ideas on how to do this.

Seventh and finally, globalization is affecting security and commerce in profound ways, and this trend has implications for our industry. In Afghanistan our troops fight alongside forces from a wide coalition of other friendly nations, and we anticipate that in the future it will be rare indeed that we fight alone. In the industry that supports these international security efforts, we likewise simply cannot avoid or wall ourselves off from globalization. Depending on the program, from a few percent to much more of the value-added in defense goods and services is sourced overseas – mostly to companies that serve as subcontractors to U.S. primes and that provide, for example, a particular specialized part. Sometimes that is where the best technology or best value can be found, and when it is, we owe it to the warfighter to do so. Globalization of our market is not an option - it is a reality. Our utilization of, for lack of a better term, “non-heritage” firms is essential for nearly all of the systems upon which we rely. We are committed to continue opening our markets while at the same time striking the appropriate balance with security concerns. Just as we have opened our markets to the leading firms from around the world, we urge our partner nations to do likewise. Exports obviously strengthen our industry’s competitiveness, but they also enhance our security – and international security – when they build the capacities of international partners. We are doing our part by implementing President Obama’s reforms of our antiquated export control regulations and procedures, and we expect our efforts will result in increasingly open and fair competitions around the globe.

To summarize, our goals in the new era for our defense industry are:

- A strong, vibrant, and financially successful defense industry,
- Structural change largely through market forces but adjusted where the interests of the taxpayer and warfighter require,
- Preserving and enhancing competition,
- Equal attention to the health of smaller and mid-sized companies, spinouts, new entrants, and service providers,
- Encouraging open entry into the defense marketplace, and
- Full advantage taken of the opportunities of globalization.

Each case or transaction will of course be different, and we will approach them case-by-case. But these will be our guideposts.

We look forward to continuing to work with our partners in the defense industry to promote the objectives of the Better Buying Power initiatives and the goal of a strong, technologically vibrant, and financially successful defense industry. My purpose in raising these guideposts today is to begin the process of dialogue and transparency that will lead to an outcome beneficial to the warfighter and the taxpayer – and the employees and shareholders of the defense industry that supports them.

Thank you.



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"Better Buying Power: Guidance for Obtaining Greater Efficiency and Productivity
in Defense Spending"

Guidance Roadmap

Target Affordability and Control Cost Growth

- Mandate affordability as a requirement
 - At Milestone A set affordability target as a Key Performance Parameter
 - At Milestone B establish engineering trades showing how each key design feature affects the target cost
- Drive productivity growth through Will Cost/Should Cost management
- Eliminate redundancy within warfighter portfolios
- Make production rates economical and hold them stable
- Set shorter program timelines and manage to them

Incentivize Productivity & Innovation in Industry

- Reward contractors for successful supply chain and indirect expense management
- Increase the use of FPIF contract type where appropriate using a 50/50 share line and 120 percent ceiling as a point of departure
- Adjust progress payments to incentivize performance
- Extend the Navy's Preferred Supplier Program to a DoD-wide pilot
- Reinvigorate industry's independent research and development and protect the defense technology base

Promote Real Competition

- Present a competitive strategy at each program milestone
- Remove obstacles to competition
 - Allow reasonable time to bid
 - Require non-certified cost and pricing data on single offers
 - Require open system architectures and set rules for acquisition of technical data rights
- Increase dynamic small business role in defense marketplace competition

Improve Tradecraft in Services Acquisition

- Create a senior manager for acquisition of services in each component, following the Air Force's example
- Adopt uniform taxonomy for different types of services
- Address causes of poor tradecraft in services acquisition
 - Assist users of services to define requirements and prevent creep via requirements templates
 - Assist users of services to conduct market research to support competition and pricing
 - Enhance competition by requiring more frequent re-compete of knowledge-based services
 - Limit the use of time and materials and award fee contracts for services
 - Require that services contracts exceeding \$1B contain cost efficiency objectives
- Increase small business participation in providing services

Reduce Non-Productive Processes and Bureaucracy

- Reduce the number of OSD-level reviews to those necessary to support major investment decisions or to uncover and respond to significant program execution issues
- Eliminate low-value-added statutory processes
- Reduce by half the volume and cost of internal and congressional reports
- Reduce non-value-added overhead imposed on industry
- Align DCMA and DCAA processes to ensure work is complementary
- Increase use of Forward Pricing Rate Recommendations (FPRRs) to reduce administrative costs