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ACQUISITION,
TECHNOLOGY
AND LOGISTICS

MEMORANDUM FOR ACQUISITION PROFESSIONALS

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

On June 28, I wrote to you describing a mandate to deliver better value to the taxpayer and warfighter by improving the way the Department does business. I emphasized that, next to supporting our forces at war on an urgent basis, this was President Obama's and Secretary Gates' highest priority for the Department's acquisition professionals. To put it bluntly: we have a continuing responsibility to procure the critical goods and services our forces need in the years ahead, but we will not have ever-increasing budgets to pay for them. We must therefore strive to achieve what economists call productivity growth: in simple terms, to DO MORE WITHOUT MORE. This memorandum contains specific Guidance for achieving the June 28 mandate.

Secretary Gates has directed the Department to pursue a wide-ranging Efficiencies Initiative, of which this Guidance is a central part. This Guidance affects the approximately $400 billion of the $700 billion defense budget that is spent annually on contracts for goods (weapons, electronics, fuel, facilities etc., amounting to about $200 billion) and services (IT services, knowledge-based services, facilities upkeep, weapons system maintenance, transportation, etc., amounting to about another $200 billion). We estimate that the efficiencies targeted by this Guidance can make a significant contribution to achieving the $100 billion redirection of defense budget dollars from unproductive to more productive purposes that is sought by Secretary Gates and Deputy Secretary Lynn over the next five years.

Since June, the senior leadership of the acquisition community – the Component Acquisition Executives (CAEs), senior logisticians and systems command leaders, OSD officials, and program executive officers (PEOs) and program managers (PMs) – has been meeting regularly with me to inform and craft this Guidance. We have analyzed data on the Department's practices, expenditures, and outcomes and examined various options for changing our practices. We have sought to base the specific actions I am directing today on the best data the Department has available to it. In some cases, however, this data is very limited. In these cases, the Guidance makes provision for future adjustments as experience and data accumulate so that unintended consequences can be detected and mitigated. We have conducted some preliminary estimates of the dollar savings anticipated from each action based on reasonable and gradual, but steady and determined, progress against a clear goal and confirmed that they can indeed be substantial.

Changing our business practices will require the continued close involvement of others. We have sought out the best ideas and initiatives from industry, many of which have been adopted in this Guidance. We have also sought the input of outside experts with decades of experience in defense acquisition.

Going forward we will need the support of Congress, which will be essential to the success of this endeavor and we have tried to take their concerns fully into account in formulating this Guidance.

A capable, qualified, and appropriately sized acquisition workforce will be key to achieving efficiency. While Secretary Gates has directed a scrub of the oversight staff in OSD and the military commands, he has also determined that the acquisition workforce increases planned last year should proceed, since they are focused on specific skill sets near to the point of execution. You, the acquisition leaders, and your workforce will be essential to the success of this Guidance.

This Guidance contains 23 principal actions to improve efficiency organized in five major areas. Specific guidance is contained in directives I am issuing today or in the near future. Over the coming months, the acquisition leadership will discuss with each of you how you can implement this Guidance and monitor progress against its metrics.

There is every reason to believe the efficiencies we are seeking can be realized. It has taken years for excessive costs and unproductive overhead to creep into our business practices, but over the coming years we can surely work them out again. Those who hesitate to go down the road of greater efficiency must consider the alternative: broken or cancelled programs, budget turbulence, uncertainty and unpredictability for industry, erosion of taxpayer confidence that they are getting value for their defense dollar and, above all, lost capability for the warfighter in a dangerous world. Not only can we succeed: we must.

TARGET AFFORDABILITY AND CONTROL COST GROWTH

Mandate affordability as a requirement. Affordability means conducting a program at a cost constrained by the maximum resources the Department can allocate for that capability. Many of our programs flunk this basic test from their inception. As the Department begins new programs like the Ohio-class SSBN(X) replacement, the new Presidential Helicopter, the Army's Ground Combat Vehicle (GCV), and the joint Family of Systems for long-range strike in the near future, I will require program managers to treat affordability as a requirement before granting milestone authority to proceed with the program. *Specifically, at Milestone A, my Acquisition Decision Memorandum (ADM) approving formal commencement of the program will contain an affordability target to be treated by the program manager (PM) like a Key Performance Parameter (KPP) such as speed, power, or data rate – i.e., a design parameter not to be sacrificed or compromised without my specific authority. At Milestone B, when a system's detailed design is begun, I will require presentation of a systems engineering tradeoff analysis showing how cost varies as the major design parameters and time to complete are varied.* This analysis would allow decisions to be made about how the system could be made less expensive without loss of important capability. This analysis would then form the basis of the 'Affordability Requirement' that would be part of the ADM decision. I will be issuing a directive in the near future to implement this guidance that will apply to both elements of a program's life cycle cost – the acquisition cost (typically 30 percent) and the operating and support cost (typically 70 percent). For smaller programs, the CAEs will be directed to do the same at their level of approval. I recognize that we need to improve the Department's capability to perform this kind of engineering tradeoff analysis, but the ability to understand and control future costs from a program's inception is critical to achieving affordability requirements.

The Navy has been conducting just this sort of analysis in connection with the commencement of the Ohio-class replacement. This submarine will be the bulwark of our survivable nuclear deterrent for the indefinite future as required by the Nuclear Posture Review, but at the price originally estimated, its construction would swamp the Navy's shipbuilding budget during the 2020-2030 periods. By conducting the kind of design tradeoffs I will require at Milestone B and trimming requirements as a result without compromising critical capability, the Navy has reduced the estimated average procurement cost by 16 percent with a goal of fully 27 percent. Over the next five years, the Department expects to begin new programs with acquisition costs in the FYDP of over $50 billion and totaling over $200 billion. If the forecast costs of these new programs can be scrubbed down by even a fraction of that achieved in the SSBN(X) program, billions of dollars just within the FYDP can be reallocated to more productive purposes.

Drive productivity growth through Will Cost/Should Cost management. During contract negotiation and program execution, our managers should be driving productivity improvement in their programs. They should be scrutinizing every element of program cost, assessing whether each element can be reduced relative to the year before, challenging learning curves, dissecting overheads and indirect costs, and targeting cost reduction with profit incentive – in short, executing to what the program *should cost*. The Department's decision makers and Congress use independent cost estimates (ICE) – forecasts of what a program *will cost* based upon reasonable extrapolations from historical experience – to support budgeting and programming. While ICE Will Cost analysis is valuable and credible, it does not help the program manager to drive leanness into the program. In fact, just the opposite can occur: the ICE, reflecting business-as-usual management in past programs, becomes a self-fulfilling prophesy. The forecast budget is expected, even required, to be fully obligated and expended.

To interrupt this vicious cycle and give program managers and contracting officers and their industry counterparts a tool to drive productivity improvement into programs, *I will require the manager of each major program to conduct a Should Cost analysis justifying each element of program cost and showing how it is improving year by year or meeting other relevant benchmarks for value. Meanwhile, the Department will continue to set the program budget baseline (used also in ADMs and Selected Acquisition Reports (SARs)) using an ICE.* We will use this method, for example, to drive cost down in the Joint Strike Fighter (JSF) program, the Department's largest program and the backbone of tactical air power for the U.S. and many other countries in the future. This aircraft's ICE (Will Cost) average unit price grew from $50 million Average Unit Procurement Cost (APUC) when the program began (in 2002 dollars, when the program was baselined) to $92 million in the most recent ICE. Accordingly, the JSF program had a Nunn-McCurdy breach last year and had to be restructured by the Secretary of Defense. As a result of that restructuring, a Should Cost analysis is being done in association with the negotiation of the early lot production contracts. The Department is scrubbing costs with the aim of identifying unneeded cost and rewarding its elimination over time. The result should be a negotiated price substantially lower than the Will Cost ICE to which the Department has forecasted and budgeted. Secretary Gates indicated in his Efficiency Initiative that monies saved in this way could be retained by the Service that achieved the efficiency; in this case the Air Force, Navy, and Marine Corps could reallocate JSF funds to buy other capabilities.

The Department will obligate about $2 trillion in contracts over the next five years according to Will Cost estimates, so savings of a few percent per year in execution are significant.

The metric of success for Should Cost management leading to annual productivity increases is annual savings of a few percent from all our ongoing contracted activities as they execute to a lower figure than budgeted. Industry can succeed in this environment because we will tie better performance to higher profit, and because affordable programs will not face cancellation.

Eliminate redundancy within warfighter portfolios. The Army recently determined that it could forego the Non-Line-of-Sight Launch System (NLOS-LS) short-range guided missile because it already had weapons that had some (though not all) of the same features as NLOS-LS and because the cost of NLOS-LS – almost $300,000 each – was too high for the narrow capability gap it would fill. This was a classic value decision that could not have been made by looking at the NLOS-LS program in isolation. The Army had to look at the entire "warfighting portfolio" of precision weapons to see that NLOS-LS's cancellation would not, in fact, result in a major sacrifice of military capability.

I intend to conduct similar portfolio reviews at the joint and Department-wide level with an eye toward identifying redundancies. These reviews will initially cover Ground Moving Target Indicator (GMTI) systems and Integrated Air and Missile Defense. *I am directing the components to do the same for smaller programs and report the results.* The savings from these reviews cannot be estimated until they are conducted, but the savings could be substantial.

Make production rates economical and hold them stable. Government and industry both benefit from economic order quantity (EOQ) rates of production, and from stability in production year after year. Unfortunately, quantity cutting and turbulence to meet budget targets is widespread. Production rates are a critical part of any acquisition strategy approved by me. *Therefore, beginning immediately, I will expect production rate to be part of the affordability analysis presented at Milestones A and B. Furthermore, at Milestone C, I will set a range of approved production rates. Deviation from that range without my prior approval will lead to revocation of the Milestone.*

Recent examples where the Department ensured cost savings by implementing economical production rates include the Navy's E-2D Advanced Hawkeye program and the Air Force's Small Diameter Bomb II program. During reviews for initial production for both programs, business case analyses demonstrated significant dollar savings and more rapid achievement of operational capability, with the use of aggressive but attainable production profiles. Those EOQs were directed and are expected to realize savings of $575 million for the E-2D and $450 million for the SDB II as a result.

I expect to see a 5 percent annual increase in the number of ACAT 1D and 1C programs executing at their EOQ level.

Set shorter program timelines and manage to them. The leisurely 10-15 year schedule of even the simplest and least ambitious Department programs not only delays the delivery of needed capability to the warfighter, but directly affects program cost. As all programs compete for funding, the usual result is that a program settles into a level-of-effort pattern of annual funding that does not deviate much from year to year. The total program cost is the level-of-effort times the length of the program. Thus a one-year extension of a program set to complete in 10 years can be expected to result in 10 percent growth in cost as the team working on the project is kept on another year.

Yet managers who run into a problem in program execution generally cannot easily compromise requirements and face an uphill battle to obtain more than their budgeted level of funding. The frequent result is a stretch in the schedule.

An example of the importance of addressing schedule directly as an independent variable is the Army's GCV. An initial acquisition plan had this program taking approximately 10 years to complete a first production vehicle, typical of the normal leisurely pace of programs. (In contrast, the MRAP-ATV began in 2009 and delivered more than 5,700 vehicles to Afghanistan by August 2010.) Given the large investment in ground vehicle technology made in the cancelled Future Combat Systems (FCS) program, there was no need to take this much time, especially if the basic requirements were limited to those essential to an infantry fighting vehicle and incorporating the lessons of recent wars. The Department determined that the GCV program should have a seven-year schedule to first production vehicle. Requirements and technology level for the first block of GCVs will have to fit this schedule, not the other way around. *When requirements and proposed schedules are inconsistent, I will work on an expedited basis with the Services and the Joint Staff to modify requirements as needed before granting authority for the program to proceed. In particular, I will not grant authority to release requests for proposals until I am confident requirements and proposed schedules are consistent. From now on, I will also require as part of the cost tradeoff analysis at Milestone B to support affordability, a justification for the proposed program schedule. This justification will be part of the ADM authorizing the program to proceed. Deviation from that schedule without my prior approval will lead to revocation of the Milestone.*

INCENTIVIZE PRODUCTIVITY AND INNOVATION IN INDUSTRY

Reward contractors for successful supply chain and indirect expense management. The Department pays profit/fee to prime contractors on work they conduct themselves, work subcontracted by the prime contractor to subcontractors, and allowable overhead and administrative costs. All three are appropriate, but in each instance the level of profit should be calculated to reward performance. Profit on subcontracted work is meant to compensate the prime for taking on the burden of managing subcontractor risk and delivering subcontractor value. Otherwise, the government would have to manage the subcontractor itself (an alternative called "breakout"). It follows that higher profit should be awarded to management of higher-risk subcontracts, and higher profit should be given when the prime succeeds in driving down subcontractor costs every year. Likewise, profit on overhead should incentivize control of overhead cost. There is evidence, however, that blanket profit levels are set and, what is more, are not revisited periodically in light of actual performance. This should be done as a matter of course. Additionally, incentives have not kept pace with fundamental changes in the defense industrial environment, among them the growth of services contracts and a shift in the role of prime contractors from manufacturers to integrators of components manufactured by subcontractors.

I am instructing the Director of Defense Procurement and Acquisition Policy (DPAP) to review the Weighted Guidelines for profit with the aim of emphasizing the tie between profit and performance. In the meantime and effective immediately, I expect all managers of ACAT 1D programs to provide to me, as part of their acquisition strategy, the reward and incentive strategy behind their profit policy, including consideration of breakout alternatives where

appropriate. I direct the CAEs to do the same in programs for which they have acquisition authority.

It is important to note that the savings to be expected from this direction will be in cost, not in profit. Savings are not expected in profit per se since in some instances profit will increase to reward risk management and performance. But if profit policy incentivizes reduction in program cost, the overall price to the taxpayer (cost plus profit) will be less.

The value of considering a breakout option is illustrated by the results of a recent review of DDG-51 Destroyer costs. During this review, it was noted that the new cost for the Restart Main Reductions Gears (MRG), previously subcontracted by two construction shipyards as Class Standard Equipment, was now more than three times the previous cost. The incumbent manufacturer had exited the market for MRGs and had sold its intellectual property to another firm. The prime passed on this subcontractor's new bill to the government without aggressive cost management. The PEO broke out the MRG from the prime contract and conducted a full and open competition, which resulted in savings over $400 million to the government for a lot buy of nine ship sets.

<u>Increase the use of Fixed-Price Incentive Firm Target (FPIF) contract type where appropriate using a 50/50 share line and 120 percent ceiling as a point of departure</u>. Choosing contract type is one important way of aligning the incentives of the government and the contractor. One size does not fit all. At one time, the Department attempted to impose fixed-price contracts on efforts where significant invention (and thus unknowable costs) could be anticipated. More recently, Cost Plus Award Fee (CPAF) contracts with subjective measures of award fee not clearly tied to cost control became widespread. In between these extremes is the FPIF contract, which should be the contracting officer's point of departure whenever conditions obtain (or can be created) that make it appropriate. "Fixed Price" is appropriate when the government knows what it wants and does not change its mind, and when industry has good control of its processes and costs and can thus name a price. While these preconditions do not always exist (as in, for example, a risky development where invention is needed), they are certainly desirable, and both parties to the contract should aspire to fulfilling them. "Incentive" is important, since it shares the costs of overruns and rewards of underruns between government and industry, giving both sides of the transaction an incentive for good performance. FPIF will normally be appropriate early in production and in single-source production where year-on-year price improvement can be rewarded.

A 50/50 share line suggests that the government and contractor have a common view of the likely contract execution cost. A 50/50 share line should represent a point where the estimate is deemed equally likely to be too low or too high. A flat or steep share line suggests that the government and contractor do not see project cost the same way. These differences in view should be discussed and considered as the basis for adjusting the target cost before an uneven share line is agreed to in contract. This might occur, for example, earlier in a program where the costs are inherently more uncertain.

A ceiling of 120 percent on an FPIF contract sets a 20 percent limit on the government's liability for overrun of the contract target cost. This is reasonable in view of historical experience in program overruns, and also reasonable because programs that overrun more than this amount in an era of relatively flat defense budgets should face review with an eye to cancellation.

A higher proposed ceiling requires explanation to the relevant head of contracting authority. Likewise, a lower ceiling than 120 percent suggests that perhaps a firm fixed-price contract is appropriate.

I am considering whether to issue more formal guidance on this matter, but effective immediately, I will require a justification of contract type for each proposed contract settlement be made to the relevant acquisition executive before negotiations are concluded. The metric for success of this measure would be fewer programs that overrun their cost targets.

The Navy, for example, recently concluded negotiations for a multi-year procurement of 124 F/A-18 strike fighter and E/A-18 electronic attack aircraft, which will yield over $600 million (greater than 10 percent) savings to the Department and the taxpayer. The F-18 program was able to drive down cost for each lot of aircraft procured in the framework of a fixed-price incentive contract that meets the Department's objectives for realistic costs, reasonable profit, a 50/50 shareline, and a 120 percent ceiling.

Adjust progress payments to incentivize performance. The government is an exceptionally reliable customer in terms of financing. The Department pays up front and regularly, sometimes before products are delivered. The Department also finances most industry investment needed to prepare products for the defense market. The Department can therefore offer its contractors a high cash flow return on invested capital, a feature highly valued by investors. This financial environment in turn offers another opportunity to reward good performance. The Department should take advantage of this circumstance through the use of innovative contract financing methods to incentivize vendors with the time value of money in exchange for lower prices/costs. *As a matter of practice, on all fixed price type contracts, I expect that the basis of negotiations shall be the use of customary progress payments. After agreement on price on the basis of customary progress payments, the contractor shall have flexibility to propose an alternate payment arrangement for the Government's consideration.* By having determined the projected contract cost, the contracting officer should be able to determine the consideration being offered by the contractor for a more favorable payment structure. The benefits of that improved cash flow shall be documented and the contracting officer will clearly identify in the business clearance the amount of consideration the Government received for the use of the improved cash flow opportunity. *I will direct that the Director of DPAP develop for my review a cash flow model to be used by all contracting officers contemplating financing other than customary progress payments and make certain that the guidance is developed to ensure that the improved cash flow opportunities provide benefit to both industry (at both prime and subcontractor level) and the taxpayer.*

Extend the Navy's Preferred Supplier Program to a DoD-wide pilot. The Department should recognize and reward businesses and corporations that consistently demonstrate exemplary performance. The Department has experience with these types of programs in certain parts of our business. For example, the Defense Logistics Agency's Strategic Supplier Alliance (SSA) has established long term relationships with major original equipment manufacturers (OEMs) within commodity groups for parts and supplies, and they are eligible to receive contract awards on a sole source basis. SSA suppliers have their performance tracked via a vendor scorecard tool that reports administrative lead time, production lead time, percent obligations and other measures and are eligible for preferred status based upon these measures.

The Navy has announced a pilot program that would allow contracting authorities to set favorable post-award special terms and conditions that recognize those businesses and corporations that have demonstrated, over time, superior performance in delivering quality products and services, robust subcontracting management, cost containment, and on-time delivery. In the Navy's pilot, the special terms and conditions can, for example, include more favorable progress payments, higher designated ranges in the weighted guidelines, special award fee pools, and other potential post-award advantages. I believe this has significant potential to appropriately reward those corporate/business suppliers that the Department can count on to repeatedly deliver the value that we expect. *I am directing the Navy to continue to lead the pilot program but to immediately include the other Services and DoD components in order to transition to a full DoD program as soon as practical.*

Reinvigorate industry's independent research and development and protect the defense technology base. The Department reimburses industry as an allowable cost over $3 billion annually in "Independent Research and Development" (IRAD). This is one of the Department's principal investments in technology innovation, larger than any single military department's annual Science and Technology (6.1-6.3) program. Yet, we do not have insight into how or where these funds go or if they benefit the Department or promote the technological prowess of our industry. Beginning in the 1990s, the Department reduced its technical exchanges with industry, in part to ensure the "independence" of IRAD. The result has been a loss of visibility into the linkage between funding and technological purpose. Additionally, there is some evidence that the defense industry has reduced its in-house laboratory infrastructure to a point not envisioned in the 1990s.

The capability to perform work in science and technology has increased throughout the world. Data suggests U.S. world share is continuing to decline. In order to maintain our innovative edge, secure the basis for a strong economy, and provide for national security, we must implement new policies to effectively use Department resources and maintain appropriate investment in technology development and lower cost and time required for providing those capabilities.

Understanding that industry needs to maintain independence, but acknowledging that the public funds these investments, I am reviewing how we can work with industry to identify and eliminate impediments to innovation, provide better feedback to industry researchers, and better define the Department's needs to our industry partners.

I intend to take action to align the purpose of IRAD to actual practice. Unfortunately, as noted above, the Department does not have the information about how the program is actually functioning that I would need to undergird a policy change at this time. Accordingly, I am today directing three steps that I will review in six months with the objective of issuing a directive on this subject at that time. First, the Director of Defense Research and Engineering (DDR&E) should engage with the largest of the performers of IRAD to collect data on how they have used these funds in recent years, the resulting benefits to government and industry, and how they obtain insight into technical areas of potential interest to the government. Second, I will ask the Defense Contract Audit Agency (DCAA) to collect and provide to me IRAD financial data from all firms with allowable IRAD costs. Third, I direct the DDR&E to provide to me within 60 days a plan for a pilot program, to improve the return on IRAD investments for industry and

government. The pilot program is to apply to as much as a third of the IRAD allocation, and will reflect early insights from the data we will collect.

PROMOTE REAL COMPETITION

Real competition is the single most powerful tool available to the Department to drive productivity. Real competition is to be distinguished from a series of directed buys or other contrived two-source situations which do not harness the full energy of competition. Competition is not always available, but evidence suggests that the government is not availing itself of all possible competitive situations.

Present a competitive strategy at each program Milestone. Since it is not practical to develop two of everything the Department needs, competition must be found in other forms. Program managers should have a competitive strategy for their program even if they do not have classic head-to-head competition. This might take the form of a related program that could serve as partial substitute for the program in question, a plan to re-gain competition in an unproductive sole source situation, breakout of subcontracted work, adapting commercial products, or other strategies.

I will require a presentation of a competitive strategy for each program at each Milestone and expect the CAEs to do the same at their level.

A highly successful example of a competitive strategy is the Navy's Littoral Combat Ship. This program was in danger of falling into a pattern of directed buys rather than real competition, with the result that the price of an LCS was creeping up towards that of a destroyer. The Navy decided to select only one of the LCS designs for production, doing so in an additional competitive selection. Competition in a different form will then be introduced into the program, as other shipbuilders are provided the technical data to build the same ship design competitively. This strategy is expected to save the Navy over $1 billion over the FYDP, with additional savings expected over the life of the LCS acquisition program.

Remove obstacles to competition. In recent years, the Department has achieved the highest rates of competition in its history. Having said that, the fact is that a significant fraction of those competitive procurements have involved what is termed "ineffective competition," since only one offer to a solicitation was received even when publicized under full and open competition. This occurs in about $55 billion of Department contracts annually. One step the Department can take is to mitigate this loss of savings from the absence of competition. A common practice has been to conclude that either a bid or proposal submitted by a single offeror in response to a full and open competition met the standard for adequate price competition because the bid or proposal was submitted with the expectation of competition. As a result, no certified cost or pricing data was requested, no cost or price analysis was undertaken, and often, no negotiations were conducted with that single offeror. *Henceforth I expect contracting officers to conduct negotiations with all single bid offerors and that the basis of that negotiation shall be cost or price analysis, as the case may be, using non-certified data.*

A more important approach is to remove obstacles to competitive bidding. For example, the Air Force's PEO for Services reviewed the Air Force's Design and Engineering Support Program (DESP) for effective competition. She found 39 percent of the task order competitions under the

Indefinite Delivery/Indefinite Quantity (IDIQ) contract resulted in one bid. The Air Force team undertook an analysis to determine why they were getting the one bid and made two changes. First, they amended their source selection methodology so that technical, cost, and past performance factors were more equally weighted. No one factor can be less than 25 percent or more than 50 percent. This served to lessen the advantage of the incumbent contractor since the technical factor could not overshadow past performance and cost. Second, the team provided a monthly report to all DESP IDIQ holders listing all known requirements in the pipeline. The report includes sufficient information to allow contractors to evaluate whether or not to bid and to start to prepare a bid package. The team has effectively added an additional 45 days to the time a requirement is made known to the potential offerors and the bid due date. These two changes have reduced the percentage of task orders receiving one bid by 50 percent. The team continues to evaluate its processes to further reduce the percentage.

Each service component and agency has a competition advocate. *I am directing each competition advocate to develop a plan to improve both the overall rate of competition and the rate of effective competition. Those plans should establish an improvement rate of at least 2 percent per year for overall competition and an improvement rate of at least 10 percent per year for effective competition. Those plans are to be approved by the CAEs. The Department's competition advocate shall brief me on the overall progress being made to achieve those goals.*

- *Require open systems architectures and set rules for acquisition of technical data rights. At Milestone B, I will require that a business case analysis be conducted in concert with the engineering trade analysis that would outline an approach for using open systems architectures and acquiring technical data rights to ensure sustained consideration of competition in the acquisition of weapons systems.* A successful example of the strategic use of open architecture and buying of appropriate technical data rights is the Navy's Virginia-class SSN program. The Virginia program uses a modular open systems architecture and selective sub-component technical data rights procurement that promotes a robust competition at the component supplier level, while still supporting continual and effective block upgrades to the existing systems that reduces the overall life cycle cost of the system.

Increase dynamic small business role in defense marketplace competition. Small businesses have repeatedly demonstrated their contribution to leading the nation in innovation and driving the economy by their example of hiring over 65 percent of all new jobs and holding more patents than all the nation's universities and large corporations combined.

Our defense industry must leverage that innovation and opportunity into our competitions, as small business representation on programs has demonstrated lower costs to the government. For many small businesses, subcontracting on Department contracts is the first step to becoming a Department prime contractor. Components must understand the small business capabilities within their industry and increase market research and outreach efforts to ensure small business utilization is maximized. In order to remove barriers to small business participation in Department contracts and competition, *I direct the CAEs to institute in all competitive and non-competitive procurement actions emphasis on small business utilization through weighting factors in past performance and in fee construct.*

IMPROVE TRADECRAFT IN SERVICES ACQUISITION

Contract support services spending now represents more than 50 percent of our total contract spending. In 2009, the Department spent more than $212 billion in contracting services, using more than 100,000 contract vehicles held by more than 32,200 contractors — with more than 50 percent of the spend awarded to about 100 contractors.

This contractor support is critical to the Department. For professional services, for example, the Department depends upon three sources: the government workforce, the unique not-for-profit FFRDCs and UARCs, and for-profit professional services companies. Management mechanisms are in place for the first two, but far less for the third.

The Department's practices for buying such services are much less mature than for buying weapons systems. It is critically important that we have a cohesive and integrated strategy with regard to the acquisition of services. This substantial amount of spend demands a management structure to strategically source these goods and services.

Create a senior manager for acquisition of services in each component, following the Air Force's example. In order to achieve efficiencies in services contracting commensurate with the scale of the Department's spend, new governance is necessary. *I am directing the CAEs of the military departments and the commanders and directors of the other DoD components to establish a senior manager for acquisition of services, who will be at the General Officer, Flag, or SES level.* This senior manager will be responsible for governance in planning, execution, strategic sourcing, and management of service contracts. The senior manager will be the Decision Authority for Category I service acquisitions valued at $250 million or less or as delegated and collaborate with requiring activities which retain funding authority on service contract spend.

Adopt uniform taxonomy for different types of services. Today, the Department lacks a standard taxonomy for service contract spend that can be used among the components to understand the Department's aggregate spending and value of specific services contracting. Without a standard approach, the Department has no way of measuring productivity in more than 50 percent of its contracting investment. *I am directing, therefore, each component to use the following primary categories of service spend: Knowledge-based services; Electronics and Communications Services; Equipment Related Services; Medical Services; Facility Related Services; and Transportation Services. These are derived from, and consistent with, Product Service Code (PSC) categories contained in the PSC manual maintained by the General Services Administration, Federal Procurement Data Center, and Office of Management and Budget (OMB). This taxonomy will be used by each component to ensure basic consistency.*

Address causes of poor tradecraft in services acquisition.

- *Assist users of services to define requirements and prevent creep via requirements templates.* The Department has experienced significant increases in mission/requirements creep for services spending, particularly in knowledge management services, which has increased 400 percent in the last decade. These requirements often require the same function or service to be provided but are written uniquely among various commands so that competition is limited. *Therefore, I am directing two initiatives to address mission/requirements creep. First, the Services and DoD components should establish, through their senior managers for services,*

maximum use of standard templates in developing Performance Work Statements (PWS) to improve contract solicitations. Successful examples of the use of standard templates are the Navy's SEAPORT acquisitions and DLA's use of templates to acquire Headquarters support services. *Second, I also expect market research to be strengthened in order to understand industry's capabilities and appropriate pricing within the market in which we are buying. I expect the military departments and DoD components will achieve this by establishing dedicated market research teams at the portfolio management level.*

o *Enhance competition by requiring more frequent re-competes of knowledge based services.* Although 89 percent of the Department's services contracting spend was awarded under competitive conditions, in 24 percent of those cases only one bid was received. This suggests bona fide competition (two or more bids) is not occurring in the $31 billion represented by those cases. To improve competition in services, *I will require the military departments and DoD components to review the length of time that services contracts remain in effect before re-competition occurs.* Single-award contract actions should be limited to three years (including options) unless, by exception, it is fully justified for longer periods by the senior manager for services. Contract length should be appropriate for the activity performed. Knowledge-based services readily meet the three-year limit. Other services such as Performance Based Logistics (PBL), LOGCAP, and environmental remediation, as examples, may not. The intent is that each service requirement will be reviewed by the appropriate official and only those with a sound business rationale will contain longer contract performance provisions. Multiple award IDIQ contracts may be up to five years if on-ramp provisions are included to refresh/update the competitor pool. In addition, *I expect Service components to align contract spend data, to the maximum extent that is practical, to the functional/requirements elements executing the spend.* This will focus all elements of the Department on the importance of achieving improved results.

o In cases where "1-bid" proposals are received, *I will require fully negotiated pricing and cost data as appropriate. Further, I will require solicitations that receive only one bid, and that were open to industry for less than 30 days, to be re-advertised for a minimum additional period of 30 days.*

o *Limit the use of time and materials and award fee contracts for services.* Today, more than 20 percent of the Department's services acquisitions are written using Time & Material (T&M) or Cost Plus Award Fee (CPAF) contract types. At a time when the Department is driving toward more fiscal discipline, we spend about $24 billion in services using T&M contract types, which are the least preferred contract type for understanding costs. Similarly, CPAF contract types provide only limited motivation for cost discipline. The acquisition of services differs greatly from the acquisition of supplies and equipment. The contractor at-risk capital is typically much lower for most service acquisitions and must be factored into the contract decision process. *I will issue further detailed guidance for establishing a taxonomy of preferred contract types in services acquisition, but starting immediately, I expect services acquisitions to be predisposed toward Cost-Plus-Fixed-Fee (CPFF), or Cost-Plus-Incentive-Fee (CPIF) arrangements, when robust competition or recent competitive pricing history does not exist to build sufficient cost knowledge of those services within that market segment. I expect thet cost knowledge gained from those contracts to inform the Should Cost estimates of future price and contract type negotiations. When robust competition already exists, or there is recent competitive pricing history, I expect components to be predisposed toward Firm-Fixed-Price*

(FFP) type contract arrangements. FFP should also be used to the maximum extent reasonable when ongoing competition is utilized in multiple award contract scenarios.

- *Require that services contracts exceeding $1 billion contain cost efficiency objectives.* With large Department outlays of capital for services contracting, it is important that the Department incentivize, achieve, and share in cost improvements over the period of performance for support services acquisitions, including knowledge management services. In acquisitions of material and production end items, we expect the contractor to be on a learning or efficiency curve to drive costs down and value up. We should incentivize and expect similar cost improvement on high-value services contracts. *Beginning immediately, I will require services contracts valued at more than $1 billion to contain provisions in the contract to achieve productivity improvements and cost efficiencies throughout the contract period.*

Increase small business participation in providing services. Small businesses provide the Department with an important degree of agility and innovation, even in support services, and they do so with generally lower overhead structures. To strengthen and improve opportunities for small businesses in the acquisition of services, *I am directing the OSD Office of Small Business Programs to review acquisition plans for services acquisitions exceeding $1 billion, and to be members of the OSD peer reviews of services acquisitions. Additionally, when multiple award contracts are used for services acquisitions, specific tasks suitable for small businesses will be set aside and military departments and DoD components will seek opportunities to compete Multiple Award/IDIQ contracts among small businesses.*

REDUCE NON-PRODUCTIVE PROCESSES AND BUREAUCRACY

Unnecessary and low-value added processes and document requirements are a significant drag on acquisition productivity and must be aggressively identified and eliminated. We cannot achieve Should Cost goals solely by providing incentives to industry to reduce overhead and increase productivity; the government must also eliminate unnecessary and often counterproductive overhead. Some of this overhead is required by statute, and I will work with the Congress to reduce these requirements that neither add value nor improve operational performance. Some of it is imposed by OSD, and is the natural bureaucratic growth in oversight that staffs generate over time and which has to be trimmed back periodically to more effective and productive levels. Secretary Gates has emphasized that the Department's efficiency initiative does not just extend to the $400 billion of contracted work outside the Department's walls, but to the $300 billion spent on the people and facilities that comprise the Department itself. He has reached into his own OSD staff and to senior commands to require greater leanness. Within OSD , he has directed my office (AT&L) to conduct a much-needed bottom-up scrub of process and staffing. Secretary Gates' determination to increase the overall acquisition workforce remains steadfast; however he intends for those additional positions to be filled with specific skill sets in short supply near the point of program execution, not an across-the-board increase or an increase in oversight staff. We must use these, and all our resources, effectively. I am calling on all participants in the acquisition system and all those who affect its processes to work with me to remove non-productive processes and bureaucracy. The following are just some of the steps we can take to address this problem:

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. The number and

frequency of OSD-level program reviews has increased significantly over the past several years. The year prior to August 2010 showed that over 240 major reviews and significant USD (AT&L)/staff reviews required more than 100,000 labor-hours to complete. This practice has tended to relieve the Senior Acquisition Executives (SAEs), PEOs, and PMs from responsibility and accountability for the programs they are executing. Insight at the AT&L level into program execution performance can generally be achieved through established status reporting mechanisms and informal staff contacts. While I expect a certain level of staff oversight, I expect the staff reviews to be focused primarily on major decision points for which I am responsible and on surfacing and solving execution problems. I also expect the OSD staff in AT&L and elsewhere to remain cognizant of our programs' progress and to identify problems quickly so that they can be dealt with as early as possible. There is a balance between this appropriate level of oversight and that which is excessive and tends to relieve the chain of command from management responsibility. I believe we have tipped the balance too far in favor of additional oversight and need to restore it to a more appropriate and effective level.

- *Realign OSD Acquisition Reviews to add more value.* It is important that we align AT&L resources to address the most significant investment decisions required at the Under Secretary level. Therefore, *I am directing ARA to review the current list of OSD reviews — DABs, Pre-DABs, OIPTs, PSRs, and TRLs etc., to recommend specific realignment of these reviews/meetings to ensure they focus their purpose on the major acquisition investment decisions made by the Department.*

- *Review DAB documentation requirements to eliminate non-relevant content.* Our DAB documents have become bloated and at the same time often fail to provide necessary and important content. A team has already been established to review DAB documents beginning with the Acquisition Strategy Report. *I am directing ARA to complete the review of all DAB documents by March 1, 2011 and to provide me with recommendations for streamlining and focusing these documents on needed content to support AT&L level decisions.*

- *Reform TRL reviews to focus on technology as opposed to engineering and integration risk.* The TRL review and certification process has grown well beyond the original intent and should be reoriented to an assessment of technology maturity and risk as opposed to engineering or integration risk. *I am directing the DDR&E to review this process and to make recommendations to refocus the TRL certification process to be consistent with its original intent.*

<u>Eliminate low-value-added statutory processes</u>. I recognize the importance of keeping programs within cost and schedule and agree on the need to reevaluate the viability of programs that incur large overruns or schedule slips. I fully support the spirit and the intention of the Nunn-McCurdy review process. However, I believe the process can be streamlined in a way that we can make sound decisions about the future of programs and provide Congress with the information and certifications they need without overly burdening programs and, in some cases, without reviewing programs that experience average unit cost growth because of decisions made by the Department, such as changed quantities resulting from requirements changes. As an example of overhead costs, my staff calculated the number of hours and attendant costs for Nunn-McCurdy evaluations that the Department undertook this year for the most recent six programs that breached the critical Nunn-McCurdy thresholds. The estimates for these six evaluations exceeded $10 million and 95,000 hours of overhead labor. Notwithstanding the legal

requirement, two of the six evaluations were for technical breaches since the breaches were the result of production quantity changes or acquisition strategy changes rather than a result of cost growth per se. The knowledge we gained by conducting full evaluations was not significantly greater than what we already knew at the outset and had no effect on the decision to continue the programs. To curb this, *I am targeting specific oversight processes, described below, to reduce or eliminate costs associated with what I believe are unnecessary overhead burdens that add marginal or questionable value to meeting the needs of our warfighters or expectations of the taxpayer. I am also directing the streamlining of some processes that are important to keep, but that require significant efficiency improvement to be effective. The Department will continue to comply with all statutory requirements, but where it makes sense we will tailor how we achieve compliance to be consistent with the circumstances, and we will work with Congress to modify statutory requirements where the intended goal is clearly not being achieved.*

o *Request Nunn-McCurdy Rules for Special Situations. I will work with Congress to eliminate the requirement for the full suite of Nunn-McCurdy assessments and reporting activities in special circumstances where quantity-induced or other external reasons cause critical breaches to occur.*

o *2366a and 2366b Certification Process Review. I will work with OSD staff and the Congress to reassess both the need for and the overall method of implementation we have imposed on ourselves to respond to the requirement for retroactive 2366a/b certifications to ensure objectives are met without burdensome and inefficient bureaucracy.*

o *Congressionally-mandated organizational changes within AT&L.* Congress has correctly identified and mandated some changes to the AT&L organization that are improving our ability to oversee acquisition programs and make better decisions about specific investments and about acquisition policy. It is important, however, that AT&L have the flexibility to balance the internal staff elements in order to effectively execute all the functions for which AT&L is responsible. *I intend to work with the Congress to ensure that all oversight functions are adequately staffed and performed without inserting inefficiencies and unnecessary overhead into the acquisition process at the same time.*

Reduce by half, the volume and cost of internal and congressional reports. The time and resources spent on one-time and recurring internal and congressional reports are costly to the Department and take the acquisition workforce away from executing programs. For internal reports, the Department must suppress its appetite for non-critical information and resist the temptation to become checkers of checkers. For congressional reports, in the past 10 years, the total number levied on the Department has grown from 514 to 719. During that same span, the number of reports assigned to my office (AT&L) grew from 102 to 156. Many of these reports, once they are introduced into legislative language, continue to be required year after year — long after the immediate relevancy and value of the information have passed. None of these reports are free. A conservative cost estimate of the resources consumed in producing the 719 congressional reports is $350 million annually. Consequently, *I am directing my staff to conduct a bottom-up review of all internally-generated reporting requirements and to work with ASD (Legislative Affairs) to conduct a bottom-up review of all congressionally mandated acquisition reports to assess the value of the reports with a goal to eliminate at least 50 percent of the reports and to substantially shorten the ones remaining. I am also tasking ARA to impose*

reasonable page count caps (given the information requested) when reports are assigned for production and to indicate the estimated cost to prepare each report on its cover.

Reduce non-value-added overhead imposed on industry. Industry has its own internal unproductive processes which add to project costs, but these are in some part a reflection of the requirements which the government imposes. A great number of the inputs I received from industry were directed at what was viewed as excessive overhead expenses based solely on non-value-added mandates and reporting requirements which may have been relevant at some point in time, but have little relevance in the world in which we now find ourselves. *In order to identify and reduce these costly requirements, I am directing the Director of Industrial Policy, with support from DPAP, to more fully survey our industrial base to identify, prioritize, and recommend a path forward to unwind duplicative and overly rigorous requirements that add to costs, but do not add to quality of product or timeliness of delivery. As we remove these requirements, I will expect a decline in the overhead charged to the Department by our industrial base that reflects these reduced costs.*

Align Defense Contract Management Agency (DCMA) and Defense Contract Audit Agency (DCAA) processes to ensure work is complementary. It is well known that during the last 20 years, due to budget constraints, DCMA and DCAA have progressively reduced staff and capability. As a result, critical functions they perform have become blurred and require clarification, and where necessary should be de-conflicted to avoid unnecessary overlap and redundancies. In this vein, industry has expressed concern regarding overlapping roles and missions between DCMA and DCAA, resulting in duplication of data requests submitted by contractors and inefficient application of Department resources. Over the past several months, at my direction, the Director of DPAP has been working with DCAA and DCMA to identify areas of potential overlapping responsibility, such as Accounting, Estimating, Purchasing, Financial Capability Reviews, Earned Value Management System (EVMS), MMAS, Property Management, and Forward Pricing, and propose methods to eliminate the duplication. *I am tasking the Director of DPAP to develop guidance that will clearly spell out the roles and responsibilities of each organization in those areas where duplication and overlap occur.*

Increase use of Forward Pricing Rate Recommendations (FPRRs) to reduce administrative costs. Contract negotiations can administratively benefit from the use of Forward Pricing Rate Agreements (FPRAs). Certainly a quality FPRA will result in reduced administrative costs associated with negotiating and managing acquisitions. However, it is also recognized that establishing FPRAs just for the sake of having FPRAs is not beneficial and has been costly to the taxpayer. For multiple reasons, including but not limited to complexity of contractor rate structures and audit process changes today, DCMA has only established 32 percent of expected FPRAs. It has, on the other hand, established 85 percent of the expected FPRRs. Clearly the opportunity exists to re-examine how best to ensure contracting officers obtain the support they need to negotiate rates. We will strive to have FPRAs, when possible, but we will not do so when FPRR's are available if we believe that there is not a legitimate and thoughtful basis for departing from them. *Accordingly, I am tasking DCMA to be responsible for the promulgation of all FPRRs. In those cases, where DCAA has completed an audit of a particular contractor's rates, DCMA shall adopt the DCAA recommended rates as the Department's position with regard to those rates.*

This letter is not the end of a process, but the beginning of vigorous implementation and further refinement. Today I have signed out directive memoranda to my key staff elements, DPAP, ARA, DDR&E, and the leaders of the OIPTs that coordinate the OSD-level oversight of major programs setting those offices on the course to begin implementing this guidance. I have provided the Component Acquisition Executives with a draft directive memorandum that I intend to sign within the next few days for their review and comments. Starting today but extending over the next several months we will be putting the actions I have described in this guidance into more formal direction and practice. Today, however, I am tasking all of you to absorb this guidance memo and begin acting on it within the scope of your existing authority. There is no time to lose.

Ashton B. Carter