

REPORT TO THE SECRETARY OF DEFENSE

Implementing Best Practices for Major Business Processes in the Department of Defense



Defense Business Board

Report FY 14-01

Recommendations for DoD's
financial management systems,
logistics and supply chain, and
human capital management

Implementing Best Practices for
Major Business Processes
in the Department of Defense



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PREFACE

This report is a product of the Defense Business Board (DBB). Recommendations by the DBB are offered as advice to the Department of Defense (DoD) and do not represent DoD policy.

The DBB was established by the Secretary of Defense in 2002 to provide the Secretary and the Deputy Secretary of Defense with independent advice and recommendations on how “best business practices” from the private sector’s corporate management perspective might be applied to the overall management of DoD. The Board’s members, appointed by the Secretary of Defense, are corporate leaders and managers with demonstrated executive-level management and governance expertise. They possess a proven record of sound judgment in leading or governing large, complex corporations and are experienced in creating reliable solutions to complex management issues guided by best business practices.

Authorized by the Federal Advisory Committee Act of 1972, the Government in Sunshine Act of 1976, and other appropriate federal regulations, the Board members are a federal advisory committee and volunteer their time to work in small groups (subcommittees) to develop recommendations and effective solutions aimed at improving DoD.



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TASK

The former Deputy Secretary of Defense (DEPSECDEF), Dr. Ashton B. Carter, asked the Defense Business Board (hereinafter referred to as “the Board”) to assess the major business issues that the Department of Defense (hereinafter referred to as “the Department”) will likely face during the period of time of the next Quadrennial Defense Review (QDR), 2014-2018. The Task Group was also asked to determine: how these issues will impact the Department; if there are existing, cost-effective measures to mitigate these issues; which successful private sector processes, practices, or techniques can be used to address these issues; and how the Department can best implement them. See Tab A for a copy of the Terms of Reference (TOR) outlining the scope and deliverables for the Task Group.

The Department faces a critical time in its history as it seeks to implement a 2014 QDR while simultaneously addressing a combination of management challenges, budget reductions, and mounting costs in the face of globally demanding operational responsibilities. The Task Group’s recommendations focused on the reforms the Department can make to several major business operations to better position itself for success in times of increased financial uncertainty.

Mr. William Phillips served as the Task Group Chair. The other Task Group members were Mr. Denis Bovin, Mr. Richard Spencer, Dr. Cynthia Trudell, and Ms. Leigh Warner. Ms. Kelsey Keating served as the staff analyst, and CAPT Stanley Keeve, US Navy and COL Leslie Caballero, US Army served as the military representatives.

APPROACH

The Task Group’s draft findings and recommendations were presented to the Board for deliberation at their January 23, 2014 quarterly meeting where the Board voted to approve the recommendations. See Tab B for a copy of the complete study with findings and recommendations approved by the Board.

In addition to drawing on their own expertise, the Task Group interviewed over 30 individuals from government, think tanks, and private industry, including current and recent DoD senior military and civilian leaders, see TAB C. The Task Group also reviewed



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reports on DoD business operations and best practices from industry, academia, think tanks, and Congressional agencies such as the Government Accountability Office (GAO), Congressional Research Service (CRS), and Congressional Budget Office (CBO).

Due to timing delays associated with administrative processes and the federal government shutdown, the Task Group could not deliver its recommendations in a timely manner to affect the QDR as initially intended. However, the recommendations provided from this study remain relevant and applicable to the Department's ongoing business operations.

BACKGROUND

The Task Group assessed several major trends to refine the study's scope.

- ★ **Historic DoD Budgets.** As the Department draws down after two wars – Operation Iraqi Freedom and Operation Enduring Freedom – its budget will necessarily shrink as a result of decreased Overseas Contingency Operations funding and planned reductions in active duty military personnel. Historically DoD budgets have shrunk 33% to 43% after major conflicts, to a floor of approximately \$400 billion, illustrated in Figure 1. Given past precedent, the Task Group believes defense budgets will continue to decline with or without forcing mechanisms such as the Budget Control Act of 2011 and Sequestration.
- ★ **Defense Missions.** Even as operations have ended in Iraq and are ending in Afghanistan, the Department continues to operate in a more dangerous and uncertain world.
- ★ **The National Debt.** The growth in US national debt will impact future DoD budgets as interest costs on the debt will increase over time and exceed defense spending by fiscal year 2019 (FY19), as depicted by Figures 2 and 3.



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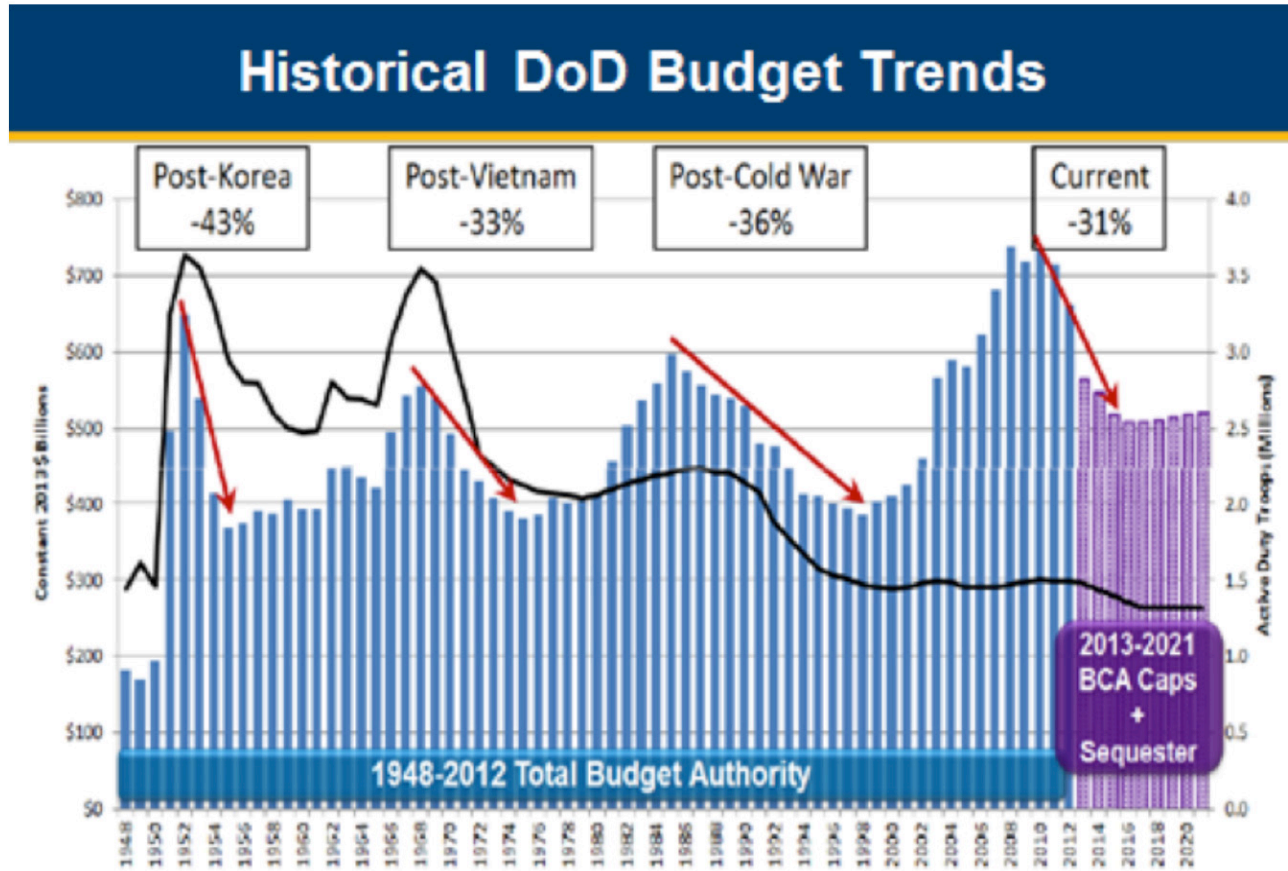


Figure 1. Past budget declines following major military engagements (Source: CSIS, February 2013; CBO estimates)



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Projected Spending in Major Budget Categories

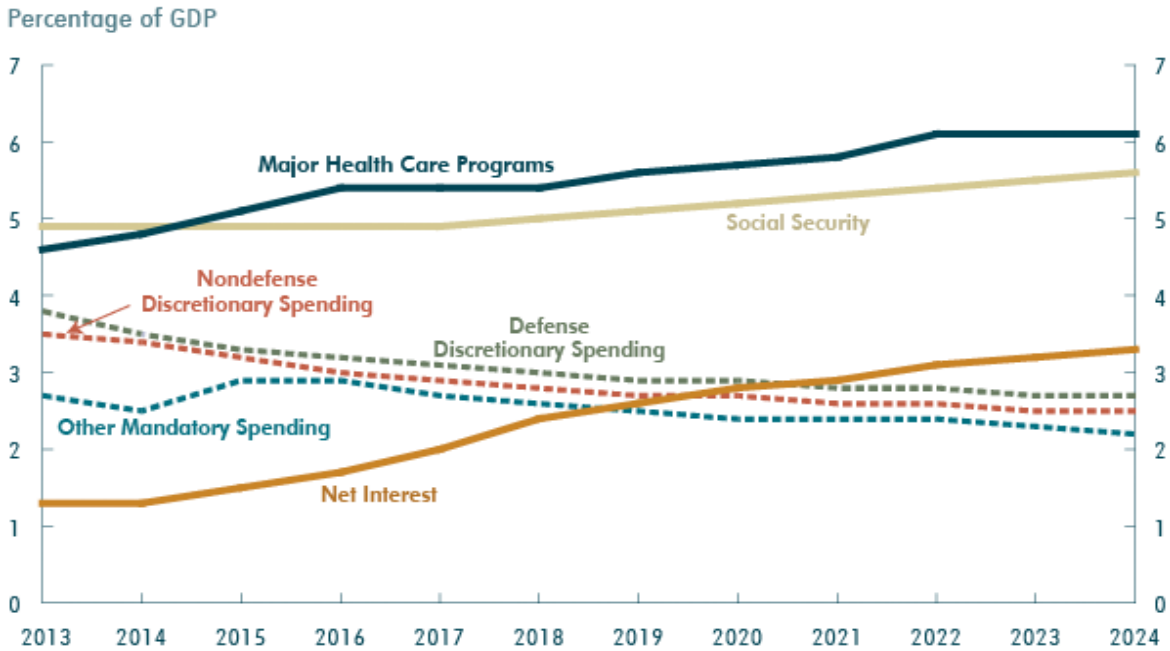


Figure 2. Projected interest on debt and the defense budget (Source: CBO February 2014)

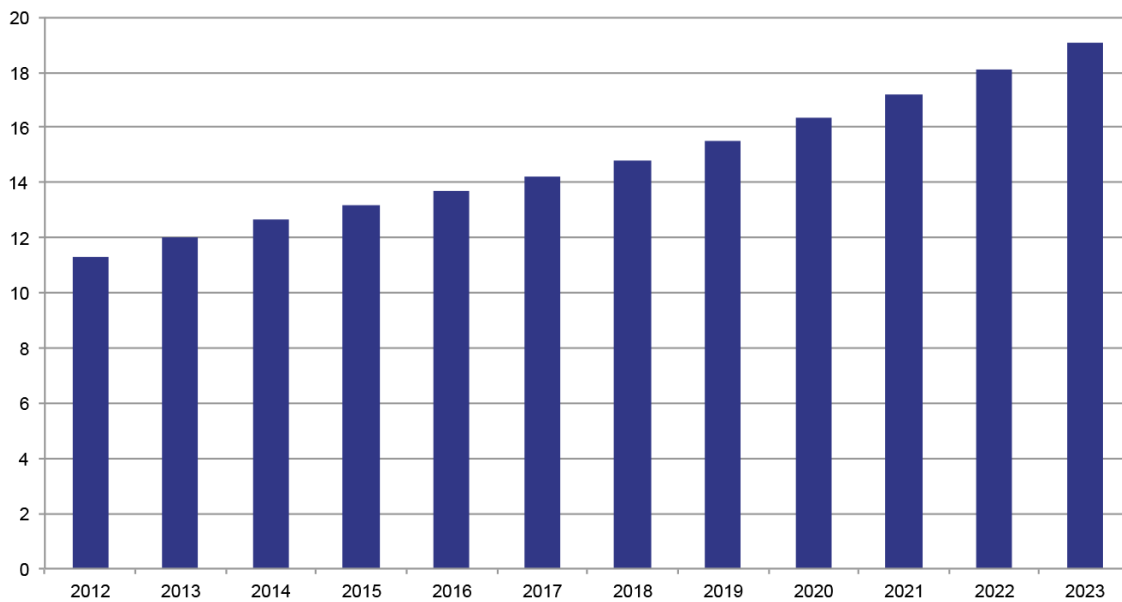


Figure 3. U.S. debt held by Public - Trillions of Dollars (Source: COB May 2013)



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BUSINESS LEADERS' RESPONSE TO FINANCIAL CHALLENGES

During times of declining budgets and increased uncertainty, successful corporate business leaders act quickly and take critical steps to address their company's challenges. Despite different circumstances, leaders all share some common approaches. They begin by assessing their leadership teams to identify and empower those ready to help, replace those who are not, and fill remaining talent gaps with highly skilled "down-budget" leaders. They then establish objectives to address the crisis-at-hand through the identification of major cost drivers: people and benefits, facilities and infrastructure, supply chain, and organizational overhead. Cuts are made quickly and transformational changes begin as the situation stabilizes.

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Case Study: IBM – In 1993, IBM's organization faced a similar situation to that of DoD today. The company was huge in size (128 people had Chief Information Officer (CIO) in their title), resources were decreasing dramatically, integration of business operations was poor (31 different internal communication networks and 155 different data centers), and organizational efficiency was mired in excessive overhead (for every dollar spent, 42 cents was in indirect costs). IBM's culture was paternalistic (outstanding yet unaffordable pensions and medical care) and it found itself operating in an environment characterized by volatility, uncertainty, complexity, and ambiguity (VUCA).

In an effort to turn around the company, IBM leadership took bold strides and established 90-day priorities in order to stop "hemorrhaging cash", right-size the organization, and identify a strong Chief Financial Officer and head of Human Resources, two of the most critical leadership positions needed to affect change. Within 12 months, IBM eliminated ~60,000 positions, consolidated 70 different advertising contracts/relationships into one, sold first class facilities and 8,000 acres of undeveloped land, and consolidated 21 corporate locations into five. Within 24 months, it consolidated 155 data centers to 16, reduced 127 CIOs to one, and reduced 30 communication networks to one. From 1994 to 1998, IBM took out \$9.5B in costs/overhead (12-15%) and grew revenue from \$64.1B in 1994 to \$81.7B in 1998. From 1994 to 2000 and beyond, IBM integrated their supply chain to improve effectiveness and eliminated over \$16B in costs.

As a result, IBM returned to profitability, regained critical market share and was once again considered one of the world's preeminent technology companies.



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Based on their review of past literature, to include IBM’s experience, and relying on their own expertise, the Task Group identified three focus areas that successful large corporations consistently addressed during times of financial uncertainty:

- 1) Financial and cost management
- 2) Logistics and supply chain management
- 3) Human capital management

The focus areas and their respective potential savings to the Department are shown in Table 1.

In determining the objective of each focus area, the Task Group established specific selection criteria:

- ★ Best business practices relevant to the current situation at DoD
- ★ Results that can begin and be achieved within the first four years of a 20-year scope (addressing sequestration requirements)
- ★ Opportunities that support mission readiness of the DoD

Focus Areas	Potential DoD Savings
1) Financial/Cost Management	<ul style="list-style-type: none">• \$4-6B savings and increased flexibility
2) Logistics and Supply Chain Management	<ul style="list-style-type: none">• \$18-23B savings and increased readiness
3) Human Capital Management	<ul style="list-style-type: none">• Reduced Layers and Span of Control: \$5-8B savings• Military Compensation and Benefits: \$1-2B savings near term, \$250-270B over 20 years

Table 1. Focus Areas and Potential DoD Savings



FINDINGS AND RECOMMENDATIONS

FINANCIAL/COST MANAGEMENT

The objective for DoD financial/cost management is to improve financial processes and systems and improve cost management through accurate and auditable financial statements. Table 2 highlights private sector financial management best business practices and corresponding key benefits when implemented. Achieving and sustaining DoD’s mandated budget cuts will require strong and deliberate financial management practices and processes.

Best Business Practice	Key Benefits
Strong financial management processes and accurate financial information	<ul style="list-style-type: none"> Enables quick response to changing conditions with more certainty
Non-financial executives spend 20-30% of their time on financial management issues	<ul style="list-style-type: none"> Unified management team focused on cost
Integration of Business systems using Enterprise Resource Planning (ERP), middleware, open source tools	<ul style="list-style-type: none"> Saves 10-25% of annual operating costs Typically replaces redundant, outdated, and expensive systems
Financial transparency to organizational leadership and investing community	<ul style="list-style-type: none"> Executives held accountable for financial goals Financial goals and objectives are shared across leadership teams Financial statements are auditable and open at public companies
Sustaining a culture of cost management – not an initiative, a continual process	<ul style="list-style-type: none"> Can reduce overhead by 5% Better informed management decisions

Table 2. Financial Management Best Business Practices and Key Benefits

The Department’s financial management system and processes have been on the GAO high risk list since 1995 and the Department continues to face major challenges in this area. The budget is known and managed, but the Department is not effectively using financial and cost systems to support better decision making. System modernization has been a priority and largely centered on Enterprise Resource Planning (ERP) systems, but its execution has been inconsistent and savings have been slow to materialize.



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A few examples of ERP initiatives in mid-FY12 are:

- ★ General Fund Enterprise Business System - \$58M/year and 107 legacy systems replaced
- ★ Navy Enterprise Resource Planning System - \$103M/96 systems
- ★ Defense Enterprise Accounting and Management System - \$56M/8 systems

Senior leaders increasingly understand the need to establish a cost culture within the Department, but implementation has been elusive. The Department is also actively investing in financial management and has the Financial Improvement and Audit Readiness (FIAR) plan in place to address auditability, but the schedule keeps adjusting to the future.

Further, the business-related Defense Agencies, which represent approximately \$60 billion of the Department’s operating costs, operate largely autonomously. See Table 3, DoD “business operations” costs. Many of these agencies provide “business operations” to the Department (e.g., Defense Information Systems Agency (DISA), Defense Logistics Agency (DLA), Defense Finance and Accounting Service (DFAS)). While the Defense Agencies are under the responsibility of a Principal Staff Assistant (PSA), those PSAs have little time to manage them. More oversight with a focus on cost controls is needed. Cost reductions are already underway at some Agencies, like DLA and DFAS, but more can be done.

Agency	Funding Type	FY2012
DLA	Direct and Working Capital	\$46.3B
DISA	Direct and Working Capital	\$8.8B
DFAS	Direct and Working Capital	\$1.4B
DeCA	Direct	\$1.4B
DCMA	Direct	\$1.2B
DSS	Direct	\$0.6B
DCAA	Direct	\$0.5B
	TOTAL	\$60.2B

Table 3. DoD “business operations” Costs (Source: Comptroller FY14 Greenbook, not adjusted for inflation. Does not include intelligence agencies and the Missile Defense Agency)



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Based on the Task Group's findings and observations, the Board recommends the Department undertake the following initiatives that implement financial management efficiencies:

- 1. Drive financial transparency for better management visibility and create a “cost management culture” throughout DoD.** This can be done by applying common business practices, metrics, and scorecard methods across the Department. The Department should continue to invest in technology enabling tools (e.g., ERP and middleware) to integrate critical business processes. Reinvigorate initiatives like Lean Six Sigma and set ambitious cost savings objectives for key business processes.
- 2. Reduce the costs of the Defense Agencies: Concentrate on Agencies whose primary mission is “business operations” (e.g. DLA, DISA, DFAS, etc.).**
 - ★ Establish aggressive cost reduction goals and performance improvement objectives. Goals should be tracked regularly using key performance indicator scorecards, and developed by leveraging what might already be in place. Start by setting 10-15% savings targets in the initial years, with 5-10% savings targets for future years. Optimize for savings using the working capital fund's account structure.
 - ★ Benchmark the agency's key processes against similar commercial sector processes and metrics.
 - ★ Create a roadmap of planned progress and require routine reporting.
 - ★ Empower the Deputy Chief Management Officer to drive this process, reporting to DEPSECDEF and the responsible PSAs. Hold each agency director accountable to achieve their established cost reduction goals.

These recommendations could result in an estimated savings of \$4-6B and increased flexibility.



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LOGISTICS AND SUPPLY CHAIN MANAGEMENT

The objective for logistics and supply chain management is to increase readiness by delivering, positioning, and sustaining forces from any point of origin to any point of employment through deeper integration of DoD’s logistics and supply chain management. Table 4 highlights private sector logistics and supply chain management best business practices and key benefits. Success in this area is directly proportional to senior executive leadership and involvement.

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Best Business Practice	Key Benefits
Integrate Supply Chain with Strategy	<ul style="list-style-type: none"> • Creates more efficient overall supply chain management • Achieves cost and competitive advantages
Strategic Sourcing	<ul style="list-style-type: none"> • Private companies typically leverage 90% of their procurement spending through strategic sourcing for savings of 10-20%
Utilize Global Information System for Real-Time Backbone	<ul style="list-style-type: none"> • Reduces fulfillment cycle times of 30-60% resulting in faster delivery • Reduces excess inventory and costs • Increases accuracy of forecasting • Ability to quickly reset distribution and delivery patterns • Improves visibility of direct and indirect costs throughout the lifecycle
Inventory Optimization	<ul style="list-style-type: none"> • Reduces inventory carrying costs • Right sizes investments in property, plants, and equipment
Utilize emerging technologies and techniques to improve business processes	<ul style="list-style-type: none"> • Enhances service delivery and reduces costs through re-design and automation • Creates enduring application of techniques like Lean Six Sigma and strategic sourcing

Table 4. Logistics and Supply Chain Management Best Business Practices and Key Benefits



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Examples from private sector experiences are:

- ★ Inventory Optimization.
 - ☆ Walmart requires major suppliers to connect directly to its own inventory management system, making suppliers responsible for retail shelf stocking.
- ★ Facilities Optimization.
 - ☆ Amazon uses consolidated warehousing and the latest technologies to drive efficiencies.
- ★ Global Information System.
 - ☆ FEDEX utilizes common IT systems and tradecraft to facilitate acquisition integration and service quality improvement.
 - ☆ IBM integrated its supply chain to decrease costs, increase procurement “hands free” transactions, and reduced maverick buying to less than 2% of total transactions.
- ★ Performance Management.
 - ☆ IBM decreased costs by 21% and increased logistics volume 30% using performance management methods.
 - ☆ Illinois Central distilled performance management to one metric that is easily understood by all levels of the organization, facilitating unity of effort.
- ★ Senior Leadership Governance of Supply Chain.
 - ☆ Ford, IBM, and Walmart rely on centralized executive “C-Suite level” management of full supply chain/logistics processes to drive continuous cost and performance improvements throughout the entire organization.
- ★ Re-design Workflow with Emerging Technologies.
 - ☆ Illinois Central became the most efficient US railroad with the best safety record through the first use of computerized traffic control.



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The Department's logistics enterprise consumes \$171.2 billion of the annual budget and is broken down into the categories of maintenance, supply, and transportation. Supply chain management has been on GAO's "High Risk List" since 1990. Current challenges include: a) multiple disconnected cost centers and processes; b) duplication from overlap that limits inventory visibility and minimizes the ability to control costs; and c) excess and aging warehouse facilities that are expensive to operate, inefficient, and underutilized.

Despite many obstacles, the Department has had several recent successes in improving its logistics enterprise. DoD established a Joint Logistics Board (JBL) to strengthen governance, and implemented a Comprehensive Inventory Management Improvement Plan (CIMIP) that decreased secondary item inventory, on-hand excess inventory, and on-order excess inventory. DLA also began the Strategic Network Optimization (SNO) initiative that focused on the transportation network, inventory management, and warehouse consolidation which produced \$1.4B in savings. These successful management initiatives have created a foundation for additional future savings, but more can be done for process improvement and further savings.

Based on the Task Group's findings and observations, the Board recommends the Department undertake the following initiatives to streamline its logistics and supply chain management:

1. Create more connectivity and streamlined processes across the logistics enterprise.

- ★ Agree to a shared taxonomy on appropriate processes and common performance metrics for greater enterprise management potential.
- ★ Avoid the temptation to build one "all inclusive" information management system/ERP. Rather, build systems in increments that leverage successes from the Military Services and DLA, with architectures that can evolve toward greater integration in the future.
- ★ Expand strategic sourcing initiatives.
 - ☆ Military Service focused initiatives offer great potential savings and

Supply chain management has been on GAO's "High Risk List" since 1990.



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adaptability.

- ☆ Lead with consistent implementation aligning the Military Services and the Department.
- ☆ Coordinate the design of all strategic sourcing programs across DoD to maximize process improvement and savings potential through Industrial Base alignment.
- ☆ Seek additional efficiencies beyond DLA commodities and depot maintenance, to include Defense Agencies' back-office support.
- ☆ Set a target of 2% savings per year of \$400B spend, (industry realizes 5-12%).

2. Continue to reduce excess depot and warehouse infrastructure and maintenance costs.

- ★ Expand excess inventory initiative; reducing to 5% excess would yield \$2-3B.
- ★ Aggressively consolidate depots to achieve efficiencies and reduce operations and maintenance (O&M) costs.
 - ☆ Target a goal of 50% reduction in Military Services' warehouse space infrastructure.
 - ☆ Services to pursue DLA SNO like efficiencies - together to yield \$1-2B.
- ★ Target 10% reduction in maintenance and related infrastructure, facilitated by troop draw-down, to potentially yield \$8B of \$79.5B FY12 maintenance costs.
- ★ Use Base Realignment and Closure (BRAC) authority to eliminate and dispose of additional excess infrastructure and streamline the supply chain.
 - ☆ Articulate to Congress the possible trades from otherwise inefficient "carrying costs."
 - ☆ Annual savings, based on earlier BRAC results, could yield \$10B over 20 years (DoD testimony – House Armed Services Committee) – early years to yield \$1-2B.
- ★ Continue to experiment with emerging technologies to facilitate adoption of supply chain efficiencies while enhancing flexibility and adaptability needed by the Total Force.

Savings through inventory and maintenance reductions, sourcing approaches and infrastructure could yield \$18-23B and increased readiness.



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HUMAN CAPITAL MANAGEMENT

Human Capital Management (HCM) is a major cost and value driver in most organizations. For this study, the Task Group focused on two specific areas that require immediate attention: 1) staffing, layers, and spans of control and 2) military compensation.

1) Staffing, Layers, and Spans of Control.

The Task Group’s objective for staffing, layers, and spans of control is for DoD to design and implement a DoD organization size and shape that optimizes speed, agility, and human resource total costs and is capable of operating within a VUCA environment. Table 5 highlights private sector best business practices and key benefits to staffing, layers, and span of control.

Best Business Practice	Key Benefits
Degree of change (incremental, transitional, transformational) and timing defined by strategic plan	<ul style="list-style-type: none"> • Incremental to transformational change yields 20-30% headcount reduction
Core work activities optimized; non-core eliminated/outsourced to “Best Provider”	<ul style="list-style-type: none"> • Core to non-core work ratio shifted from 55:45 to 70:30 through delayering, increasing spans of control and elimination/outsourcing of non-core work
Multi-year roadmaps and milestones established. Supported by a strong Program Management Office (PMO) and senior leadership oversight	<ul style="list-style-type: none"> • Improves transformational change success rate to 70%
Organization effectiveness and efficiency underpinned by fewer “touch points”, common language, core operating processes, and data architectures	<ul style="list-style-type: none"> • Enables speed and agility • Critical decision making cycle times reduced from months to weeks • Product development cycles reduced by 20%
Continuous and compelling communication to employees	<ul style="list-style-type: none"> • Re-engineered work more precise through strong employee engagement

Table 5. Staffing, Layers, and Spans of Control Best Business Practices and Key Benefits



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A few examples of private sector transformational best business practices are:

- ★ IBM.
 - ☆ Re-engineered their business model and critical processes to support enterprise leveraging and a transformed portfolio.
 - ☆ Significant delayering at the senior and middle management levels as well as headcount reductions (~150K employees) was required to accomplish the change.
 - ☆ Transformation resulted in return to strong profitable growth, market cap, and a sustained competitive business model.

- ★ General Electric.
 - ☆ Through process re-engineering, strong cultural interventions, and change management, layers reduced from 12 to 6 and spans of control increased from 3 to 10.
 - ☆ Positioned company to take advantage of new portfolio and emerging market opportunities.

The Department has taken several actions to streamline and make HCM more efficient. Recent targeted initiatives, such as the Army's reduction of soldiers and Brigade Combat Teams and the Air Force's reduction of aircraft, have resulted in streamlined operations, reductions in headcount, and lowered operating costs. However, these reductions are insufficient to meet current sequestration expectations.

The DEPSECDEF's initiative (July 31, 2013 memorandum) to reduce headquarters staff by 20% indicates continued commitment to cost management; however, this initiative only covers a small percentage of the people costs embedded in overhead activities and favors near-term over long-term cost savings. In FY12, the Department spent \$152.6B for military pay and \$77.2B for civilian pay equaling an estimated total of \$230B on manpower pay. Although the Services have followed DEPSECDEF's lead with decentralized initiatives to accomplish targets, overall a decentralized approach runs the risk of sub-optimizing the required changes for future DoD effectiveness.



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Based on the Task Group's findings and observations, the Board recommends the Department implement the following strategy for organizational change:

1. Commit to transformational change (5+ years) with strong program management and senior leadership oversight.
2. Execute in "Waves" for manageability and sustainability.
 - ★ Wave 1: **Incremental** initiatives that yield immediate headcount reduction and cost savings.
 - ★ Wave 2: **Transitional** initiatives that align and leverage core business processes that yield further efficiencies and effectiveness. This enables readiness for implementing fundamental changes informed by DoD.
 - ★ Wave 3: **Transformational** initiatives that enable future mission capability per DoD's future strategy.
3. Target an appropriate Military personnel/Civilian personnel/Contract Services cost and population "mix" ratio. The objective will be to yield \$8B savings per year by 2018.
4. Hold the Senior Executive Service Accountable. Fully utilize the performance management system for Senior Executive Service accountability.

The Task Group noted that Congress must play a critical supporting role to implement these types of changes, and with estimated savings of \$5-8B per year, Congress should be supportive.

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2) Military Compensation.

The end-state objective for military compensation is an affordable compensation and benefits system that attracts and retains the best and brightest personnel, and is configured to meet the demands of the mission.



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Table 6 highlights private sector best business practices and key benefits in the area of compensation and benefits.

Best Business Practice	Key Benefits
Strong alignment between compensation and performance management systems	<ul style="list-style-type: none"> • Supports delivery of high performance and rewards for results
Understanding compensation and benefit value through the “lens” of the employee using Conjoint Analysis	<ul style="list-style-type: none"> • Provides a more objective platform to support senior management in making compensation and benefit tradeoff decisions. Note, a typical US company wastes ~\$1500/employee/year on compensation and benefits • Provides best value opportunity to both employer and employees. Often benefits are over- or under-valued stemming from poor understanding and/or inadequate communication/marketing
Transition to defined contribution plans from defined benefit (DB) plans	<ul style="list-style-type: none"> • Reduces volatility of existing liabilities. Provides employee flexibility/portability. Average private sector pension contributions range from 4-12% per year
Changes to business strategy, and/or organization structures accompanied by targeted changes to the compensation system	<ul style="list-style-type: none"> • Promotes greater organizational alignment and efficiencies
High and low performing employees are compensated accordingly for their results within a company – wide performance management system	<ul style="list-style-type: none"> • Incentivizes and rewards strong performers while providing valuable feedback to lower performing employees
Recognition of importance of benefits beyond base pay (e.g., flexible working hours, geographical location, work structure)	<ul style="list-style-type: none"> • Increases employee satisfaction and promotes efficiencies • Allows for non-cash benefits to be incorporated into pay/benefits spectrum

Table 6. Compensation Best Business Practices and Key Benefits



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The Task Group observed that legacy compensation and benefits systems have not been adjusted to support and sustain the All-Volunteer Force since its creation in 1973. In 1970, Thomas Gates chaired a study on the All-Volunteer Force and identified three critical components to be addressed in order for the All-Volunteer Force to be successful: (1) military compensation, (2) the up or out promotion structure, and (3) military retirement; key issues the Department has yet to address.

Legacy systems are designed to support career personnel with little attention given to the majority of Service members (those serving fewer than 20 years). Legacy systems are ill-equipped to manage the talent attraction and retention requirements presented by the Iraq and Afghanistan wars, leading to costly reactionary increases in compensation and benefits. Furthermore, Military Service members are not fully educated on the value of their overall benefits packages.

Consequently, DoD personnel costs are on an unsustainable trajectory and forecasted to consume the entire DoD budget by 2030.

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- ★ Basic pay for the average service member from January 2002 to January 2010 increased by 29% adjusted for ECI (this includes previously planned restoration pay); housing allowances increased by 83%, and the subsistence (food) allowance increased by 40% in nominal dollars.
- ★ Enlisted and officer cash compensation is at the 90th and 83rd percentiles, respectively, when compared to civilians with comparable education. DoD goal has been 70th percentile.
- ★ With the legacy pension structure of 20 year cliff vesting and a 2.5 multiplier (1.1 for private sector), only 17% of enlisted military personnel will receive a pension with a disproportionate vesting amongst the officer population (~40%).

Currently, for each dollar spent on basic pay, DoD contributes 33 cents to the Military Retirement Fund (MRF). In FY12, DoD and Treasury contributed \$21.9B and \$70.1B,



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respectively, to the MRF, for a net total of \$92B. As of FY11, the MRF pension liability is ~70% unfunded of a \$1,273B actualized accrued liability. A recent statistically limited conjoint analysis indicates DoD could benefit from utilizing this methodology on a larger scale to more fully understand what the current, diverse workforce truly values. Findings requiring further validation include:

- ★ A dollar spent increasing enlisted personnel basic pay has more than six times the impact than a dollar spent increasing senior officer basic pay.
- ★ One-third of officers value commissaries as much or more than they cost; when compared to less than 6% of enlisted who value it in the same manner.
- ★ Majority of Military Service members value military exchanges as much or more than they cost.
- ★ More than 75% of junior officers and 99% of all other rank groups do not value child, youth, and school services as much as it costs to provide.

Based on the Task Group's findings and observations, the Board recommends the Department implement the following:

1. Develop and implement an Human Capital Management plan. A plan that transitions over the next five years to a compensation and benefits framework that is sustainable and supports the attraction and retention requirements of the All-Volunteer Force.

- ★ Define the near and long-term talent retention requirements from enlistment to retirement (e.g., Army enlisted personnel ~4 years versus Air Force pilots 20 year retirement) to develop a framework for delivering value and capability to Service personnel during their tenure.
- ★ Using the retention requirement framework, address compensation and benefits as a system, not simply individual products (regular military compensation (RMC), bonuses, special pay, retirement, commissary, healthcare, etc.).
- ★ Develop and administer a statistically significant, multi-cohort, conjoint analysis in FY14. Learn from the current system and beyond which compensation and benefit element combinations (tangible and intangible) have the highest perceived value within the various groups.



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- ★ Design a flexible HCM system to be competitive with the private sector for attraction and retention of needed talent. Manage unsustainable basic pay “creep” through continued utilization of targeted bonuses and incentives to meet requirements. Employ analytical modeling to assure best value and avoid overpaying.
- 2. Make near-term adjustments to compensation.** Utilize the current force draw down to make near-term reasonable adjustments to the “premium” difference between the military and private sector compensation.
- ★ Rigorously communicate and educate personnel on the value of their total compensation and benefits package (improve pay stub information, annual summary of total benefits paid, etc.).
 - ★ Slow basic pay growth rate by implementing DoD recommended pay raise schedule: 0.5% (2015), 1.0% (2016), 1.55% (2017). Basic pay would remain relatively flat over this time period and below projected employment cost index levels with reduced accrual payments into the MRF.
 - ★ Evaluate the reinstatement of cost sharing for housing allowances to both reduce costs and incentivize Service members to utilize recently renovated government housing with a goal of saving 10% of the costs (approximately \$11B over ten years).
- 3. Transition to a Defined Contribution plan.** Work vigorously with Congress to address the unsustainable cost structure, fairness, and flexibility issues of the Military’s Defined Benefit (DB) Retirement Plan.
- ★ Adopt the DBB recommendation to create a Defined Contribution (DC) plan for new enlistments using the existing Military Thrift Savings Plan to include the following.
 - ☆ Service personnel under current DB plan grandfathered.
 - ☆ Average vesting of 4 years, payout at age 60-65 with flexible payout options.
 - ☆ Risk adjusted to recognize combat roles and hardship
 - ☆ Opportunity of ~\$0.5B reduced future fund liability by FY34.



Defense Business Board

- ★ To support sustained affordability through transition, consider:
 - ☆ Index payout of retirement benefits to 67 years of age.
 - ☆ Adjust benefit multiplier to 2.0 (40% of base pay) from present 2.5% (50% of base pay). Benchmarks: private sector 1.1, public and municipal 1.5, fire and police 2.0.
 - ☆ Adjust High 3 computation to High 5.
 - ☆ To further accelerate the transition to the DC plan, consider offering the choice for 1-15 year Service members of freezing their accrual in the DB plan and opting into the DC plan (financial and conjoint analyses will confirm feasibility).

CONCLUSION

The Department of Defense is facing one of the Nation's most demanding business process environments in an increasingly unpredictable world. Implementing the Board's recommendations offers the potential to increase DoD's efficiency, flexibility, and adaptability; and could potentially yield a net savings of ~\$27-37B annually. As the Services and Department make tough force structure choices in the near-term, an inward look at the "Business of the Department" is important for the future health of our Nation's military capability and the All-Volunteer Force.

Respectfully submitted,

William R. Phillips
Task Group Chair

TERMS OF REFERENCE

TAB A



DEPUTY SECRETARY OF DEFENSE
1010 DEFENSE PENTAGON
WASHINGTON, DC 20301-1010

MAY 26 2013

MEMORANDUM FOR CHAIRMAN, DEFENSE BUSINESS BOARD

SUBJECT: Terms of Reference, "Addressing Major Business Issues Facing the Department in the 2014 Quadrennial Defense Review"

The Quadrennial Defense Review (QDR) is the comprehensive study by the Department of Defense (DoD) that analyzes strategic objectives and potential military threats. As stipulated in the National Defense Authorization Act (NDAA) for Fiscal Year (FY) 1997, the QDR is to be conducted every four years, and its publication is required to coincide with the issuance of the next year's budget request. Furthermore, Congress has already created the National Defense Panel to assess the 2014 QDR recommendations.

The QDR provides critical guidance on how the nation's defense force is shaped and employed. DoD will draft the 2014 QDR at a time when DoD faces an extraordinary combination of management challenges, budget reductions, and mounting costs. This QDR should reflect the growing influence of external business issues.

As the DoD's advisory board for recommending private sector best business practices, the Defense Business Board (DBB) is directed to conduct, through a DoD established Task Group, a study to identify and assess the major business issues that the Department likely will face through the period of the next QDR. I further request that the study identify potential strategies that the 2014 QDR should consider to address these issues. The Task Group should consider the trends in the following areas: macroeconomic environment; technology; energy, resource use, and availability; personnel and health care costs; and information technology. At a minimum, the study should address the following questions:

- What are the major business issues that the DoD and the QDR should consider?
- How will these issues affect DoD?
- Are there any existing, cost-effective measures that DoD can implement to mitigate these issues?
- What successful private sector processes, practices, and techniques can DoD use to address these issues?
- How can DoD best implement these processes, practices, and techniques?

The Office of the Under Secretary of Defense for Policy will serve as the primary DoD liaison for this study and provide technical assistance, as needed.



OSD005769-13

As a subcommittee of the DBB, this Task Group must comply with the Federal Advisory Committee Act of 1972, the Government in the Sunshine Act of 1976, federal regulations, and DoD policies and procedures. This Task Group shall not work independently of the DBB's charter and shall report its recommendations to the DBB for full deliberation and discussion. The Task Group does not have the authority to make decisions on behalf of the DBB, nor can it report directly to any Federal officer or employee. The Task Group will avoid discussing "particular matters" with the meaning of section 208 of title 18 U. S. Code.

A handwritten signature in black ink, reading "Ashton B. Carter". The signature is written in a cursive style with a large, sweeping initial 'A'.

*COMPLETE STUDY WITH FINDINGS
AND RECOMMENDATIONS
PROVIDED TO THE BOARD ON
JANUARY 23, 2014*

TAB B

DEFENSE BUSINESS BOARD



Implementing Best Practices for Major Business Processes in the Department of Defense

January 23, 2014

These are the final briefing slides as approved by the Defense Business Board in its public meeting held on January 23, 2014. The full DBB report will contain more detailed text which will reflect the totality of the points discussed and any modifications adopted by the Board during their deliberations.

Agenda

- Terms of Reference Overview
- Approach
- Influences on the DoD Environment
 - Trends
- Major Business Issues Challenging DoD
 - Financial Management
 - Logistics and Supply Chain Management
 - Human Capital Management
- Closing Remarks



Terms of Reference Overview

- Address trends that will affect DoD during the period of the next Quadrennial Defense Review (QDR), 2014-2018
- Identify and assess the major business issues that the Department will likely face through the period of the next QDR
 1. What are the major business issues that the Department should consider?
 2. How will these issues impact the Department?
 3. Are there any existing, cost-effective measures that the Department can implement to mitigate these issues?
 4. What successful private sector processes, practices, and techniques can DoD use to address these issues?
 5. How can the Department best implement these processes, practices, and techniques?



Approach

- Review past DoD QDR reports
- Review relevant DoD “business operations” activities
- Interview 30+ private industry and current/recent DoD senior military and civilian leaders on DoD “business operations” and QDR development process*
- Research “best business practices” – industry, academia, think tanks, DoD, and Congressional agencies (GAO, CRS, CBO)
- Identify best business practices and processes

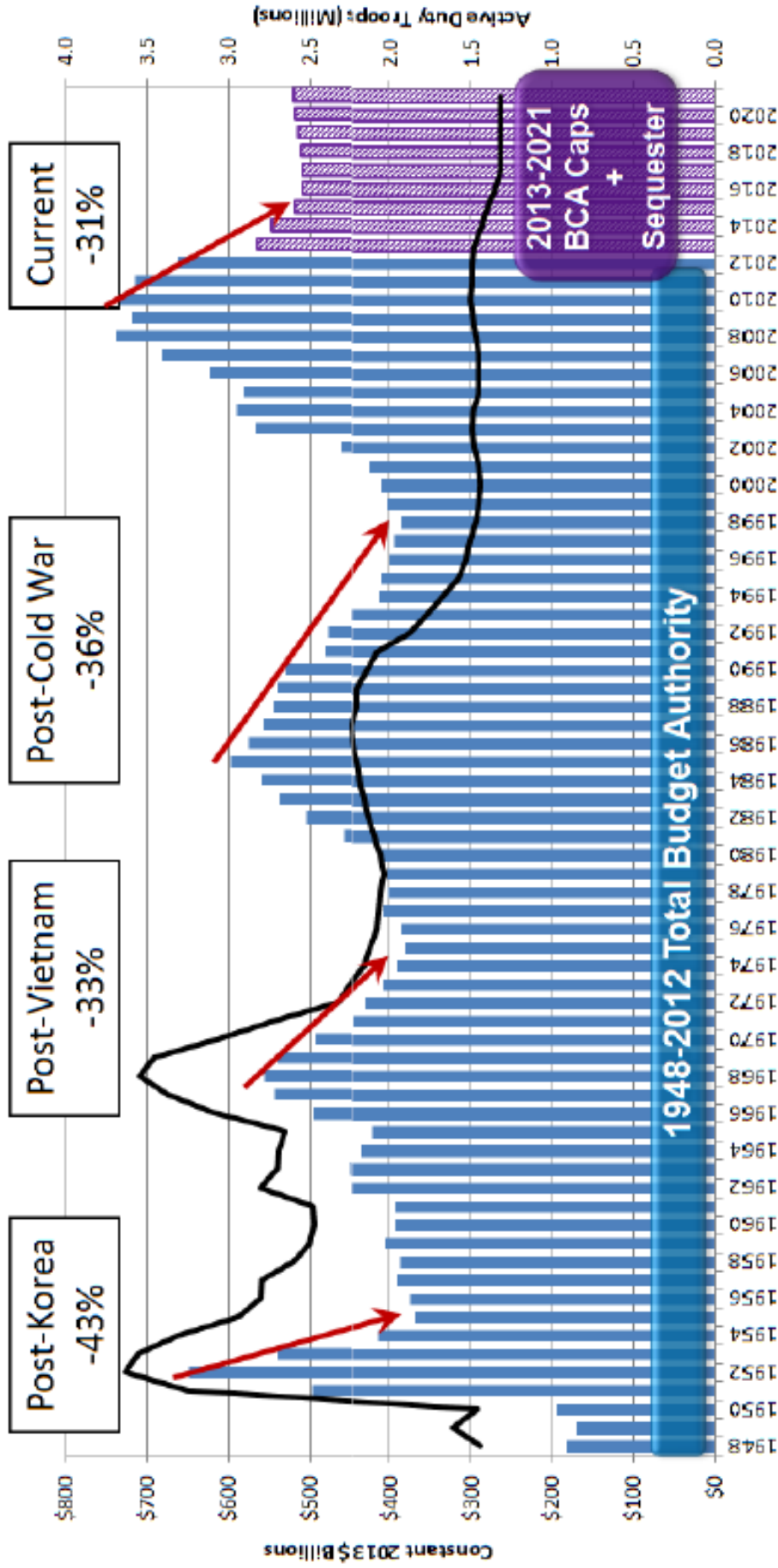
Note: DoD delays and furloughs have impacted the timeliness of this study as it applies to the QDR 2014 report

* Note: Appendix lists officials interviewed



Major Trends

Defense Budgets following OEF/OIF will mirror past major conflicts drawdowns



Source: CSIS, Feb 2013; CBO estimates

Future budget constraints will impact DoD

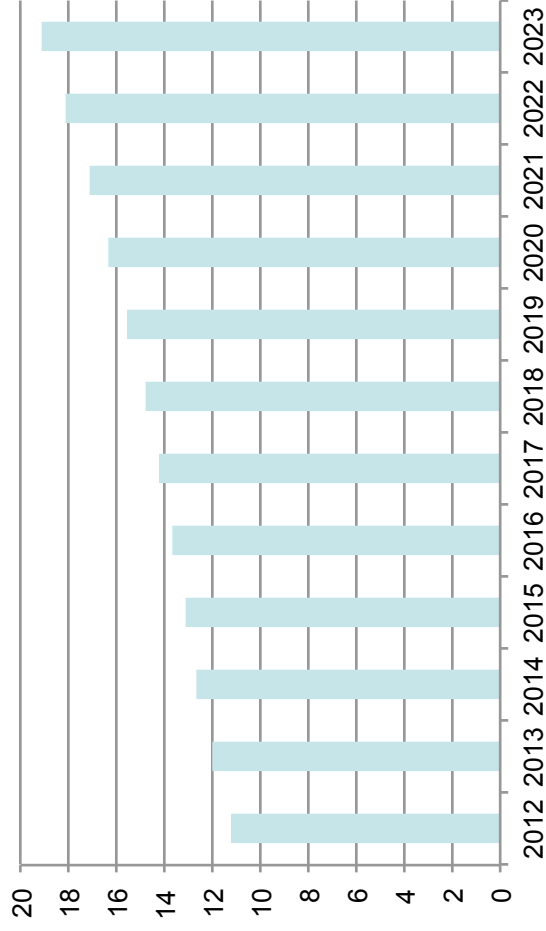


Major Trends

Debt is the Driving Factor

- Defense budgets will continue to decline with or without sequestration
- Defense missions continue: drawdown occurring in a more dangerous and uncertain world
- Interest costs will exceed defense spending by FY19
- Business dimension of DoD is critical element in addressing this problem

Debt Held by Public



Source: CBO May 2013, in \$ Trillions

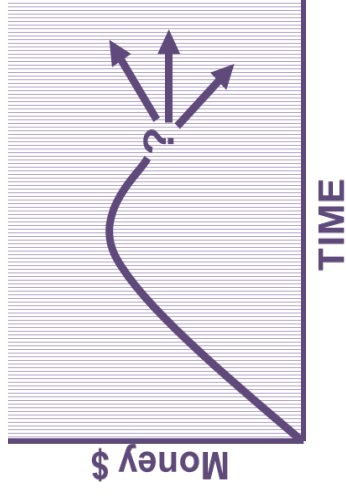
U.S. Debt growth will impact future DoD budgets



Tough Times

What Business Leaders Do When Faced with Financial Challenges

- **Assess their leadership teams**
 - Who's ready to help? (empower)
 - Who's not? (replace)
 - Fill talent gaps with highly skilled “down budget” leaders
- **Establish objectives that address the crisis at hand**
- **Look at major cost drivers**
 - People and benefits
 - Facilities and infrastructure
 - Supply chain
 - Organizational overhead
- **Conduct triage**
 - Early days not pretty – cut costs as fast as possible
 - Once stable, offer more transformational approaches



The Business Situation ... IBM 1993

- **Organization characterized by**
 - Huge size – everything is measured in \$billions
 - Resources are decreasing dramatically – also measured in \$billions
 - Integration of business operations is poor - financial, supply chain, IT...
 - Organizational efficiency is poor – years of increasing resources have led to increased overhead, redundancy, and inadequate focus on cost
 - Major decisions aren't debated, rather handled through “pre-arranged consensus”
 - Paternalistic: Outstanding yet unaffordable pensions and medical care
- **Operating environment increasingly characterized by volatility, uncertainty, complexity and ambiguity (VUCA)**
 - Who and where the “bad guys or our competition” are is changing
- **For every dollar of resource achieved, 42 cents is in indirect costs [1]**
- **Duplication, redundancy and excess exist:**
 - 128 people have CIO in their title
 - 266 different general ledger systems
 - 31 different internal communication networks
 - 155 different data centers



What IBM Did

- Established 90 day priorities, including
 - Stop hemorrhaging cash
 - Right-size the organization
 - Identify strong CFO and head of HR
- Focused on specific actions
 - Cut costs: eliminate redundant activities, non-core functions, and cut overhead dramatically
 - Reduce unnecessary facilities and real estate immediately
 - Address costs of people through right-sizing and changes to benefit plans
 - Sell assets determined to be non-core but with significant value in the market
- Within 12 months
 - Right-sized the organization, eliminating ~60,000 positions
 - Consolidated redundant activities (e.g. 70 different advertising contracts/relationships into 1)
 - Sold 8,000 acres of undeveloped land, sold first-class facilities, consolidated 21 corporate locations into 5

“Move fast. If we make mistakes, let them be because we moved too fast rather than too slow.” -- Lou Gerstner 1993



What IBM Did

- Within 24 months
 - Consolidated 155 data centers to 16
 - Eliminated 127 CIOs to having only 1
 - Eliminated 30 communication networks to only 1 today
- From 1994 to 1998 took out \$9.5B in costs/overhead (12-15%)
 - Revenue grew from \$64.1B in 1994 to \$81.7B in 1998
- From 1994 to 2000 and beyond, integrated supply chain
 - Improve effectiveness while eliminating in excess of **\$16B** in costs

Strong leaders, with specific goals, moving quickly to target costs



Business/Management Issues for DoD 2014

- **Narrowed the Study Scope Using Selection Criteria**
 - Best Business Practices relevant to current situation at the DoD
 - Results that can begin and be achieved within the first four years of a 20-year scope, addressing sequestration requirements
 - Opportunities that support mission readiness of the DoD

- **Focus Areas:**

1) Financial/Cost Management	<ul style="list-style-type: none">▪ \$4-6B savings and increased flexibility
2) Logistics and Supply Chain	<ul style="list-style-type: none">▪ \$18-23B savings and increased readiness
3) Human Capital Management	<ul style="list-style-type: none">▪ Reduced Layers and Span of Control: \$5-8B savings▪ Military Compensation and Benefits: \$1-2B savings near term, \$250-270B over 20 years

These recommendations could yield \$27-37B* savings over the next 4-5 years while enhancing outcomes

* Note: Recognizing that savings are not additive as focus area savings likely to have some overlap



Financial Management

Best Business Practices

Objective: Improve financial processes and systems and improve cost management through accurate and auditable financial statements

Best Business Practice	Key Benefits
Strong financial management processes and accurate financial information	<ul style="list-style-type: none"> Enables quick response to changing conditions with more certainty
Non-financial executives spend 20-30% of their time on financial management issues	<ul style="list-style-type: none"> Unified management team focused on costs
Integration of Business systems using Enterprise Resource Planning (ERP), middleware, open source tools	<ul style="list-style-type: none"> Saves 10-25% of annual operating costs Typically replaces redundant, outdated, and expensive systems
Financial transparency to organizational leadership and investing community	<ul style="list-style-type: none"> Executives held accountable for financial goals Financial goals and objectives are shared across leadership teams Financial statements are auditable and open at public companies
Sustaining a culture of cost management – not an initiative, a continual process	<ul style="list-style-type: none"> Can reduce overhead by 5% Better informed management decisions

Achieving and sustaining DoD's mandated budget cuts (\$54 billion/year) will require strong and deliberate financial management practices/processes



Financial Management

DoD Today

- DoD's "Financial Management" on the Government's Accountability Office (GAO) "High Risk List" since 1995
- Budget is known and managed, however not effectively using financial and cost systems to support better decision making
- System modernization has been a priority, centered around ERPs, but execution has been inconsistent and savings slow to materialize
 - Army Logistics Management Program (LMP) anticipated \$750M in savings by end of FY12, but actual savings are unknown. No tracking mechanism in place [2]
 - Projected savings of select ERP initiatives (mid-FY12) [3]
 - General Fund Enterprise Business System - \$58M/year and 107 legacy systems replaced
 - Navy Enterprise Resource Planning System - \$103M/96 systems
 - Defense Enterprise Accounting and Management System - \$56M/8 systems



Financial Management

DoD Today

- Need for cost culture increasingly being understood but implementation is still elusive
- DoD investing in financial management. Financial Improvement and Audit Readiness (FIAR) Plan schedule in place, but slipping to the right [4]
 - FY14 Statement of Budgetary Resources goal is now focused on the more limited Schedule of Budgetary Activities
 - FY17 goal for full financial statement audit likely to move to FY18 or beyond

“We don’t typically ask ourselves about the financial or cost consequences when we make decisions in this building. Part of the problem is cultural, but part of the problem is also that we don’t have the information to answer that question.”

- Senior military leader



Financial Management

DoD Today

- Business-like Defense Agencies represent ~\$60B of DoD’s operating costs
 - Many are DoD “business operations” (e.g., DISA, DLA, DFAS, etc.)
 - Operate largely autonomously – Principle Staff Assistants (PSA) have little time to manage
 - DoD’s FY13 Budget Request suggests \$10B in total Defense Agency Savings

Agency	Funding Type	FY2012
DLA	Direct and Working Capital	\$46.3B
DISA	Direct and Working Capital	\$8.8B
DFAS	Direct and Working Capital	\$1.4B
DeCA	Direct	\$1.4B
DCMA	Direct	\$1.2B
DSS	Direct	\$0.6B
DCAA	Direct	\$0.5B

TOTAL \$60.2B

Cost reductions underway; more can be done

Source: Comptroller FY14 Greenbook, not adjusted for inflation. Does not include intelligence agencies and the Missile Defense Agency



Financial Management

DBB Recommendations

1. Drive transparency for better management visibility and create a “cost management culture” throughout DoD
 - Apply common business practices, metrics, and scorecard methods across the Department
 - Continue to invest in technology enabling tools (e.g., ERP and middleware) to integrate critical business processes
 - Re-invigorate initiatives like Lean Six Sigma and set ambitious cost savings objectives for key business processes



Financial Management

DBB Recommendations

2. Reduce costs of DoD's Defense Agencies

- Concentrate on agencies whose primary mission is “business operations” (e.g. DLA, DISA, DFAS, etc.)
- Establish aggressive cost reduction goals and performance improvement objectives
 - Track using Key Performance Indicator scorecards
 - Leverage what might already be in place
 - Optimize for savings using the working capital fund's account structure
 - Set 10-15% targets in initial years; move to 5-10% annual targets for future years
- Benchmark the agency's key processes against similar commercial sector processes and metrics
- Create a roadmap of planned progress; require routine reporting
- Empower DCMO to drive this process, reporting to DEPSECDEF and aligned PSAs
 - Hold each agency director accountable to achieve cost reduction goals

Estimated savings of \$4-6B per year



Logistics and Supply Chain Management

Best Business Practices

Objective: Increase readiness by delivering, positioning, and sustaining forces from any point of origin to any point of employment, through more deeply integrated logistics and supply chain management

Best Business Practice	Key Benefits
Integrate Supply Chain with Strategy	<ul style="list-style-type: none"> ▪ Creates more efficient overall supply chain management ▪ Achieves cost and competitive advantages
Strategic Sourcing	<ul style="list-style-type: none"> ▪ Private companies typically leverage 90% of their procurement spending through strategic sourcing for savings of 10-20%
Utilize Global Information System for Real-Time Backbone	<ul style="list-style-type: none"> ▪ Reduces fulfillment cycle times of 30-60% resulting in faster delivery ▪ Reduces excess inventory & costs ▪ Increases accuracy of forecasting ▪ Ability to quickly reset distribution and delivery patterns ▪ Improves visibility of direct and indirect costs throughout the lifecycle



Logistics and Supply Chain Management

Best Business Practices

Best Business Practice	Key Benefits
Inventory Optimization	<ul style="list-style-type: none"> ▪ Reduces inventory carrying costs ▪ Right sizes investments in property, plants, and equipment
Utilize emerging technologies and techniques to improve business processes	<ul style="list-style-type: none"> ▪ Enhances service delivery and reduces costs through re-design and automation ▪ Creates enduring application of techniques like Lean Six Sigma and strategic sourcing

Success directly proportional to senior executive leadership and involvement



Logistics and Supply Chain Management

Best Business Practices (Examples)

- Inventory Optimization
 - **Walmart** requires major suppliers to connect directly to its own inventory management system, making suppliers responsible for retail shelf stocking
- Facilities Optimization
 - **Amazon** uses consolidated warehousing and the latest technologies to drive efficiencies
- Global Information System
 - **FEDEX** utilizes common IT systems and tradecraft to facilitate acquisition integration and service quality improvement
 - **IBM** integrated its supply chain to decrease costs, increase procurement “hands free” transactions, and reduced maverick buying to less than 2% of total transactions



Logistics and Supply Chain Management

Best Business Practices (Examples)

- Performance Management
 - **IBM** decreased costs by 21% and increased logistics volume 30% using performance management methods [5]
 - **Illinois Central** distilled performance management to one metric that is easily understood by all levels of the organization, facilitating unity of effort
- Senior Leadership Governance of Supply Chain
 - **Ford, IBM, and Walmart** rely on centralized executive “C-Suite level” management of full supply chain/logistics processes to drive continuous cost and performance improvements throughout the entire organization
- Re-design Workflow with Emerging Technologies
 - **Illinois Central** became the most efficient US railroad with the best safety record though the first use of computerized traffic control



Logistics and Supply Chain Management

Scope of DoD Logistics



Source: ASD for Logistics and Materiel Readiness



Logistics and Supply Chain Management

DoD Today

- DoD's "Supply Chain Management" on GAO's "High Risk List" since 1990
- Multiple disconnected cost centers and processes
 - Military Services: Mandated by Title X for Service-unique items
 - DLA: Common supply provider (e.g., "Commodities" such as food, fuel, construction/barrier material, medical items)
 - TRANSCOM: Joint Distribution Process Owner
 - GSA: Negotiates contracts for basic goods (e.g., office supplies, tools, computer products, and cleaning products)
- Overlap leads to wasteful duplication, limits inventory visibility, and minimizes ability to control costs
- Excess and aging warehouse facilities are expensive to operate and inefficient
 - Military Services property books hold hundreds of warehouses, many underutilized; wasteful expense on aging facilities



Logistics and Supply Chain Management

DoD Today

- Recent DoD Successes
 - Established Joint Logistics Board (JLB) – strengthens governance
 - Inventory Management Enhancement
 - Comprehensive Inventory Management Improvement Plan (CIMIP)
 - Decreased secondary item inventory to \$8B as of March 2012 – largest decrease since 1990
 - Reduced “on-hand excess inventory” to 7.2% at end of March 2013, reduced \$3.4B since March 2012; target goal no more than 10% [6]
 - Decreased “on-order excess inventory” to 7.6%, reduced \$548M since 2009 [6]
 - Distribution Process Owner Strategic Opportunities (DSO) initiatives achieved \$402M in distribution cost avoidances across the FYDP beginning in FY14 [7]
 - Strategic Network Optimization (SNO) producing \$1.4B savings in transportation network, inventory, and infrastructure warehouse consolidation [6]
 - DLA materiel now consolidated and sourced from 3 primary hubs (East, Central, West)

These successful management initiatives create a foundation for additional future savings, but more work to be done on savings and process improvement



Logistics and Supply Chain Management

DBB Recommendations

1. Create more connectivity and streamlined processes across the logistics enterprise
 - Agree to shared taxonomy on appropriate processes and common performance metrics for greater enterprise management potential
 - Avoid the temptation to build one “all inclusive” information management system/ERP
 - Rather, build systems in increments that leverage successes from the Military Services and DLA while including architectures that can evolve toward integration
 - Expand strategic sourcing initiatives
 - Military Service-focused initiatives offer great potential savings and adaptability
 - Lead with consistent, implementation aligning the Military Services and the Department
 - Coordinate the design of all strategic sourcing programs across DoD to maximize process improvement and savings potential through Industrial Base alignment
 - Seek additional efficiencies beyond DLA Commodities and Depot Maintenance, to include Defense Agencies’ back-office support
 - Set a target of 2% savings per year of \$400B spend, (industry realizes 5-12%)
 - Anticipate yield of \$6-8B annually and process improvements



Logistics and Supply Chain Management

DBB Recommendations

2. Continue to reduce excess depot and warehouse infrastructure and maintenance costs
 - Expand excess inventory initiative; Reducing to 5% excess would yield \$2-3B
 - Aggressively consolidate depots to achieve efficiencies and reduce O&M costs
 - Target a goal of 50% reduction in Military Services’ warehouse space* infrastructure
 - Services to pursue SNO-like efficiencies - together to yield \$1-2B
 - Target 10% reduction in maintenance and related infrastructure, facilitated by troop draw-down, to potentially yield \$8B of \$79.5B FY2012 maintenance costs
 - Use Base Realignment and Closure (BRAC) authority to eliminate and dispose of additional excess infrastructure and streamline the supply chain
 - Articulate to Congress the possible trades from otherwise inefficient “carrying costs”
 - Annual savings, based on earlier BRAC results, could yield \$10B over 20 years (DoD testimony – House Armed Services Committee) – early years to yield \$1-2B
 - Continue to experiment with emerging technologies to facilitate adoption of supply chain efficiencies while enhancing flexibility and adaptability needed by the Total Force

Savings through inventory and maintenance reductions, sourcing approaches and infrastructure could yield \$18-23B and increased readiness

*Note: Recognize the Service controlled specialized inventory may make this challenging, but recommendation based on DLA experience



Human Capital Management

- Represents a major cost and value driver in most organizations
- Two specific areas requiring immediate attention
 - Staffing, Layers, and Spans of Control
 - Military Compensation
- As currently constituted, both are increasingly unaffordable without transformational change

What we heard from current and former defense leaders: “If I want to guarantee the future, I look to the **people side**.”

-- ADM Mike Mullen, former Chairman of Joint Chiefs of Staff



Human Capital Management Staffing, Layers, and Spans of Control

Objective: Design and implement a DoD organization size and shape that optimizes speed, agility, and human resource total costs and is capable of operating within a VUCA environment

Best Business Practice	Key Benefits
Degree of change (incremental, transitional, transformational) and timing defined by strategic plan	<ul style="list-style-type: none"> ▪ Incremental to transformational change yields 20-30% headcount reduction
Core work activities optimized; non-core eliminated/outsourced to “Best Provider”	<ul style="list-style-type: none"> ▪ Core to non-core work ratio shifted from 55:45 to 70:30 through delayering, increasing spans of control and elimination/outsourcing of non-core work
Multi-year roadmaps and milestones established. Supported by a strong Program Management Office (PMO) and senior leadership oversight	<ul style="list-style-type: none"> ▪ Improves transformational change success rate to 70%
Organization effectiveness and efficiency underpinned by fewer “touch points”, common language, core operating processes, and data architectures	<ul style="list-style-type: none"> ▪ Enables speed and agility ▪ Critical decision making cycle times reduced from months to weeks ▪ Product development cycles reduced by 20%
Continuous and compelling communication to employees	<ul style="list-style-type: none"> ▪ Re-engineered work more precise through strong employee engagement



Human Capital Management

Staffing, Layers, and Spans of Control

Best Business Practices: Transformation Examples

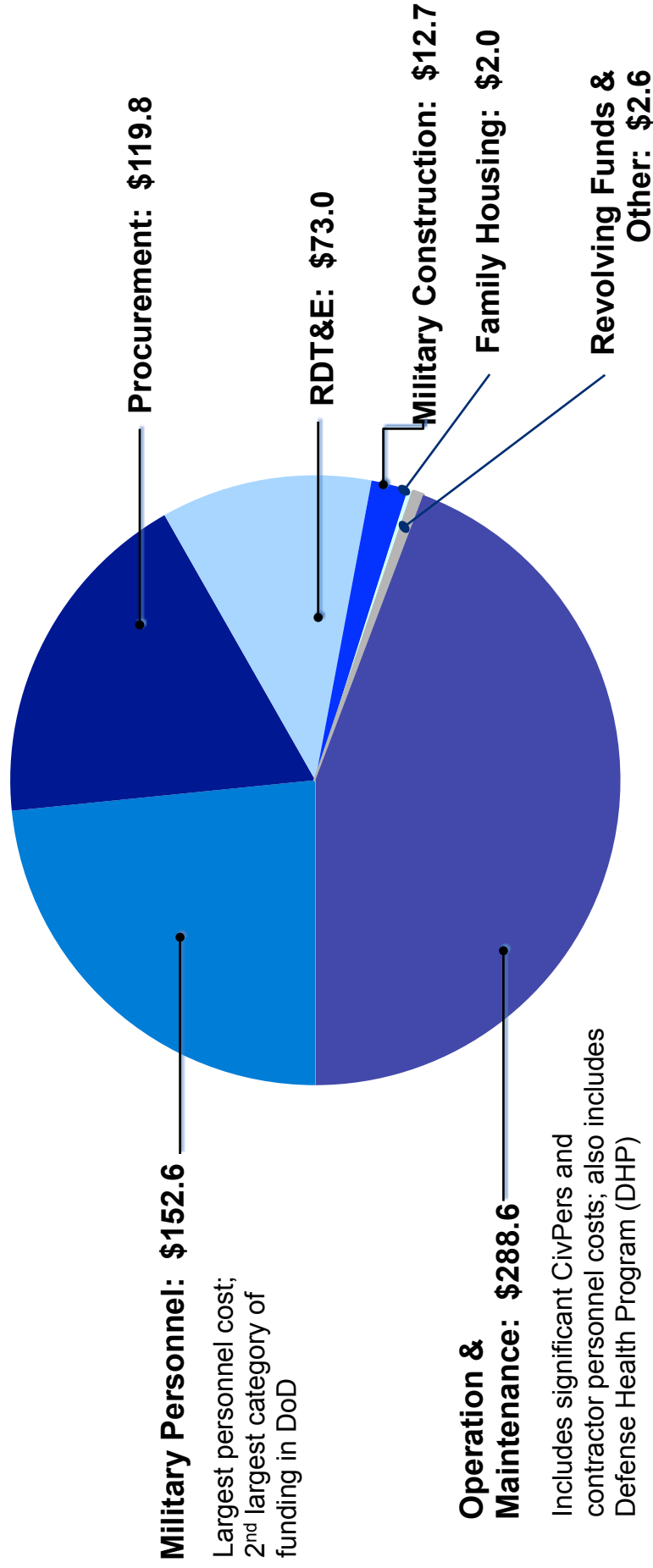
- **IBM**
 - Re-engineered their Business model and critical processes to support enterprise leveraging and a transformed portfolio
 - Significant delayering at the senior and middle management levels as well as headcount reductions (~150k employees) was required to accomplish the change
 - Transformation resulted in return to strong profitable growth, market cap, and a sustained competitive business model

- **GE**
 - Through process re-engineering, strong cultural interventions, and change management, layers reduced from 12 to 6 and spans of control increased from 3 to 10
 - Positioned company to take advantage of new portfolio and emerging market opportunities



Human Capital Management Staffing, Layers, and Spans of Control

FY12 Total Obligation Authority \$652.3B

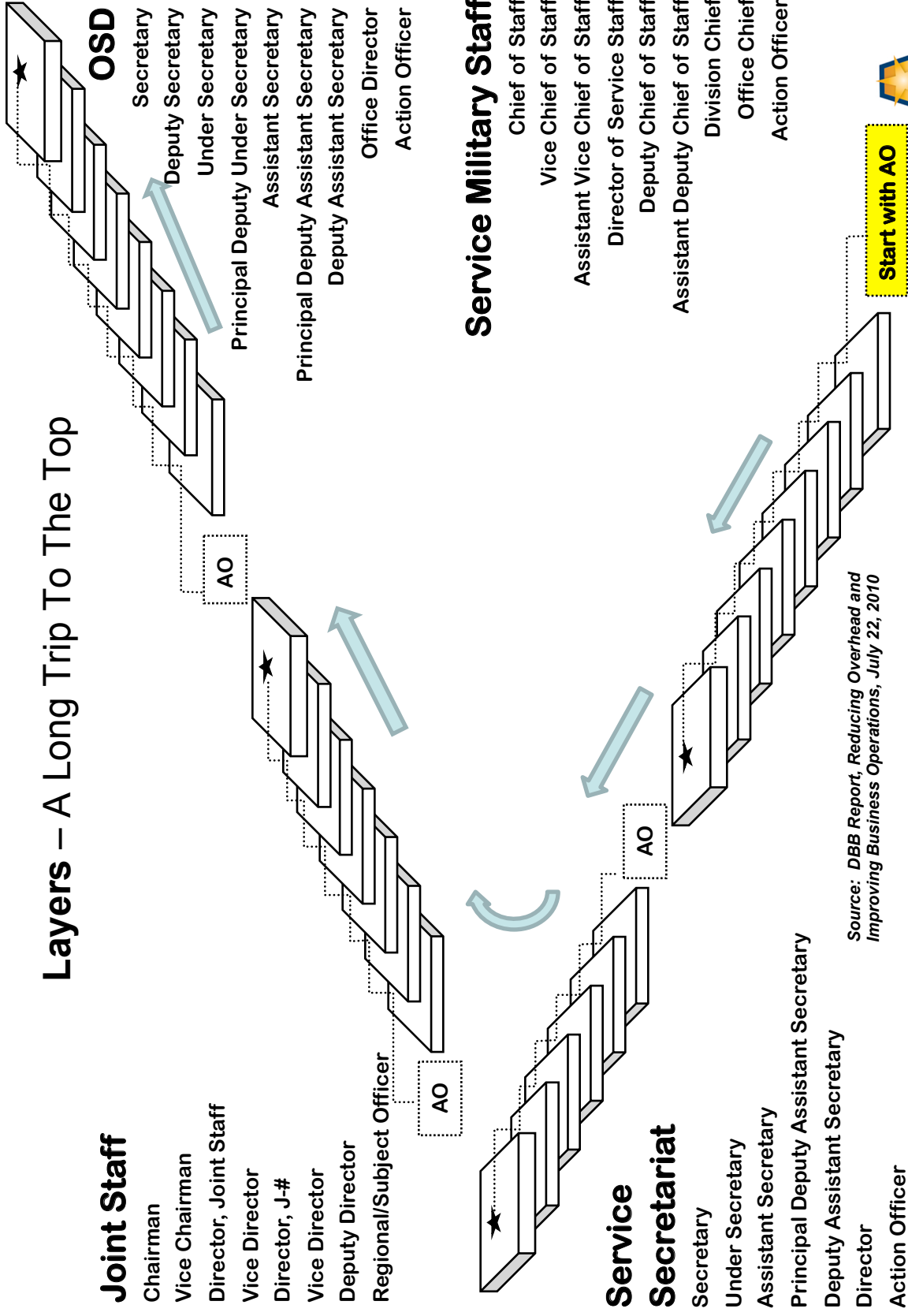


Source: FY2014 DoD Comptroller Greenbook; in FY12 current dollars



Human Capital Management Staffing, Layers, and Spans of Control - DoD Today

Layers – A Long Trip To The Top



Source: DBB Report, Reducing Overhead and Improving Business Operations, July 22, 2010

Human Capital Management

Staffing, Layers, and Spans of Control - DoD Today

- Targeted initiatives have resulted in streamlined operations, reductions in headcount and operating costs, but insufficient to meet current sequestration expectations
- Continued excess layers and costs as demonstrated by: deputies with deputies, GS-15s reporting to GS-15s, spans of control of only 1-3 staff
- DEPSECDEF initiative (7/31/13 memo) to reduce HQ staff by 20% indicates continued commitment to cost management. However:
 - Only covers a small percentage of the people costs embedded in overhead activities
 - Can offer near-term cost savings, although not the most efficient approach long-term
 - Across the board cuts without re-engineering the work have potential for increased resource costs over time
 - Services have followed DEPSECDEF lead with decentralized initiatives to accomplish targets
- Numerous examples of re-engineering operating processes at the decentralized level exist but this approach runs the risk of sub-optimizing the required changes for future DoD effectiveness



Human Capital Management

Staffing, Layers, and Spans of Control - Recommendations

1. Commit to transformational change (5+ years) with strong program management and senior leadership oversight
2. Execute in “Waves” for manageability and sustainability
 - Wave 1: **Incremental** initiatives that yield immediate headcount reduction and cost savings
 - Wave 2: **Transitional** initiatives that align and leverage core business processes that yield further efficiencies and effectiveness. Enables readiness for implementing fundamental changes informed by DoD
 - Wave 3: **Transformational** initiatives that enable future mission capability per DoD’s future strategy
3. Target a Milpers/Civpers/Contract Services cost and population “mix” ratio that would yield \$8B savings per year by 2018
4. Fully utilize the performance management system for SES accountability

Estimated Savings: \$5-8B annually



Human Capital Management

DBB Recommendations

Staffing, Layers, and Spans of Control

Wave 1 Incremental (0-2 years): Increasing Core / Non-Core Work Ratio

- Immediately expand the HQ staff initiative (7/31/13 memo) across the Department
 - All indirect organizations (overhead or tail) should reduce headcount costs at a 20% level consistent with HQ over a two year period
 - Non-core work should be scrutinized for elimination or sourced to the “Best Provider”
 - Establish span of control guidance to reduce redundancy and administrative costs (e.g., set a minimum of 1:5. Roles with less than 5 direct reports should be scrutinized, eliminated, and/or staff merged into larger groups)
 - Develop guidance to eliminate positions that report to someone at the same GS or military level (e.g. GS-15 reporting to another GS-15 should be eliminated)
 - Target a 2 management layer reduction for each organization
 - Identify those statutes, personnel policies and business practices that incent managers to utilize manpower inefficiently. Work with Congress to refine or eliminate
 - Wherever possible eliminate Milpers doing civilian work and contractors performing work that could be done by Civpers (e.g., Combatant Commands)



Human Capital Management

DBB Recommendations

Staffing, Layers, and Spans of Control

Wave 2 Transitional (1-3 years): Aligning and Leveraging Core Business Processes

- Within the Defense Agencies and Field Activities, identify and map those core business processes (e.g., logistics and supply chain, personnel) that could be aligned and leveraged to both reduce costs and increase effectiveness of service delivery
- Gap fit current organization size and shape with transitional state to develop an implementation roadmap and assure affordability within a targeted cost and population mix ratio
- Diligently deploy common language, operating processes, metrics, and data architectures
- Target an additional 10% reduction in headcount costs and an additional 2 layers of management



Human Capital Management

DBB Recommendations

Staffing, Layers, and Spans of Control

Wave 3 Transformational (3-5+ years): Aligning with Human Capital Management (HCM) Capability

- Using the 2014 QDR output, define those future mission critical capabilities and points of interface between human capital, technology and the strategy
- Gap fit required changes to the transitional organization size and shape and identify changes to the cost and population mix ratio
- Develop a HCM plan to meet emerging skill and capability requirements. Plan should comprehend recruiting, retention and compensation strategies for meeting the future needs of the DoD workforce



Human Capital Management

Military Compensation

Objective: Affordable military compensation and benefits system that attracts and retains the best and brightest. Configured to meet the demands of the mission

Best Business Practice	Key Benefits
<p>Strong alignment between compensation and performance management systems</p>	<ul style="list-style-type: none"> ▪ Supports delivery of high performance and rewards for results
<p>Understanding compensation and benefit value through the “lens” of the employee using Conjoint Analysis</p>	<ul style="list-style-type: none"> ▪ Provides a more objective platform to support senior management in making compensation and benefit tradeoff decisions. Note, a typical US company wastes ~\$1500/employee/year on compensation and benefits [8] ▪ Provides best value opportunity to both employer and employees. Often benefits are over- or under-valued stemming from poor understanding and/or inadequate communication/marketing



Human Capital Management

Military Compensation

Best Business Practice	Key Benefits
<p>Transition to defined contribution plans from defined benefit (DB) plans</p>	<ul style="list-style-type: none"> ▪ Reduces volatility of existing liabilities. ▪ Provides employee flexibility/portability. Note, only seven of the F100 companies still offer a traditional DB plan to new hires. [9] Average private sector pension contributions range from 4-12% per year
<p>Changes to business strategy, and/or organization structures accompanied by targeted changes to the compensation system</p>	<ul style="list-style-type: none"> ▪ Promotes greater organizational alignment and efficiencies
<p>High and low performing employees are compensated accordingly for their results within a company – wide performance management system</p>	<ul style="list-style-type: none"> ▪ Incentivizes and rewards strong performers while providing valuable feedback to lower performing employees
<p>Recognition of importance of benefits beyond base pay (e.g., flexible working hours, geographical location, work structure)</p>	<ul style="list-style-type: none"> ▪ Increases employee satisfaction and promotes efficiencies ▪ Allows for non-cash benefits to be incorporated into pay/benefits spectrum



Human Capital Management

Military Compensation - DoD Today

- Legacy compensation and benefits systems were not adjusted to support/sustain the All-Volunteer Force*, resulting in
 - Military Service members not fully educated on the value of their benefits package
 - Legacy systems designed to support career personnel with little attention to the majority of Military Service members
 - Legacy systems ill-equipped to manage the talent attraction and retention requirements presented by the Iraq and Afghanistan wars leading to costly reactionary increases in compensation and benefits
- Consequently, DoD personnel costs are on an unsustainable trajectory; forecasted to consume the entire DoD 2030 budget putting at significant risk national security
 - Basic pay for the average service member from Jan 2002 to Jan 2010 increased by 29% adjusted for ECI (this includes previously planned restoration pay); housing allowances increased by 83%, and the subsistence (food) allowance increased by 40% in nominal dollars [10]
 - Enlisted and officer cash compensation is at the 90th and 83rd percentiles, respectively, when compared to civilians with comparable education. DoD goal has been 70th percentile [11, 12]
 - With the legacy pension structure of 20 year cliff vesting and a 2.5 multiplier (1.1 for private sector), only 17% of enlisted military personnel will receive a pension with a disproportionate vesting amongst the officer population (~40%) [11, 12, 13]

*Note: Regular Military Compensation (RMC): 1962; Pension: 1965; transition to All-Volunteer Force: 1973



Human Capital Management

Military Compensation - DoD Today

- Currently, for each dollar spent on basic pay, DoD contributes 33 cents to the Military Retirement Fund (MRF). In FY12, DoD and Treasury contributed \$21.9B and \$70.1B, respectively, to the MRF, for a net total of \$92B [14]
- As of FY2011, the MRF pension liability is ~70% unfunded [15]
 - Reduction of forces will slow future growth
- A recent statistically limited conjoint analysis [16] indicates DoD could benefit from utilizing this methodology on a larger scale to more fully understand what the current diverse workforce truly values. Findings requiring further validation:
 - A dollar spent increasing enlisted personnel basic pay has more than six times the impact than a dollar spent increasing senior officer basic pay
 - One-third of officers value commissaries as much or more than they cost compared to less than 6% of enlisted who value it in the same manner
 - Majority of Military Service members value military exchanges as much or more than they cost
 - More than 75% of junior officers and 99% of all other rank groups do not value child, youth, and school services as much as it costs to provide

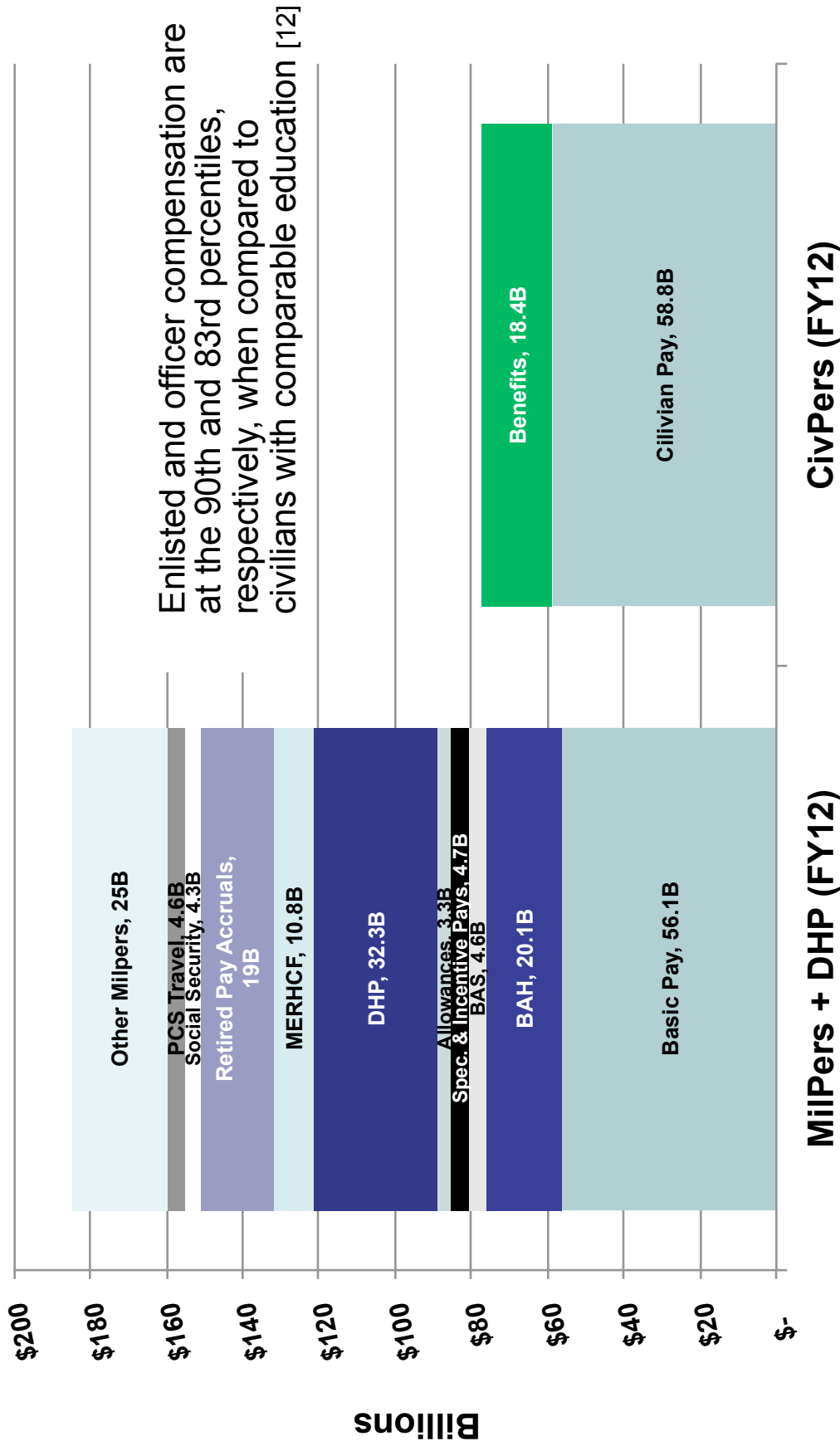
"Now that we are going to have an All Volunteer Force, we desperately need to address three critical components to support its success: military compensation, the up or out promotion structure, and military retirement."

Thomas Gates, Chair of the All-Volunteer Force Study, February, 1970



Human Capital Management

Military Compensation - DoD Today



Source: FY2014 DoD Comptroller Greenbook



Human Capital Management

Military Compensation - Recommendations

1. Develop and implement a Human Capital Management (HCM) plan that transitions over the next 5 years to a compensation and benefits framework that is sustainable and supports the attraction and retention requirements of the All -Volunteer Workforce
 - Define the near and long-term talent retention requirements from enlistment to retirement (e.g., Army enlisted personnel ~4 years vs. Air Force pilots to 20 year retirement) to develop a framework for delivering value and retentive capability to service personnel during their tenure
 - Using the retention requirement framework, address compensation and benefits as a system, not simply individual products (RMC, bonuses, special pay, retirement, commissary, healthcare, etc.)
 - Develop and administer statistically significant multi-cohort conjoint analyses in FY14. Learn from the current system and beyond what compensation and benefit element combinations (tangible and intangible) have the highest perceived value within the various groups
 - Design a flexible HCM system to be competitive with the private sector for attraction and retention of needed talent
 - Manage unsustainable basic pay “creep”, through continued utilization of targeted bonuses and incentives to meet requirements. Employ analytical modeling to assure best value and avoid overpaying



Human Capital Management

Military Compensation - Recommendations

2. Utilize the current force draw down to make near-term reasonable adjustments to the “premium” difference between the military and private sector compensation
 - Rigorously communicate and educate personnel on the value of their total compensation and benefits package (improve pay stub information, annual summary of total benefits paid, etc.)
 - Slow basic pay growth rate by implementing DoD recommended pay raise schedule: 0.5% (2015), 1.0% (2016), 1.55% (2017) [11]
 - Opportunity: basic pay would remain relatively flat over this time period and below projected Employment Cost Index levels. Reduced accrual payments into the MRF
 - Evaluate reinstating cost sharing for housing allowances to both reduce costs and incent service members to utilize recently renovated government housing with a goal of saving 10% of the costs (approximately \$11B over ten years) [10]

Estimated Savings: \$6-25B over 10 years
(dependent upon force size and required utilization of SRB's)



Human Capital Management

Military Compensation – Recommendations

3. Work vigorously with Congress to address the unsustainable cost structure, fairness, and flexibility issues of the Military's Defined Benefit Retirement Plan
 - Adopt the DBB recommendation to create a Defined Contribution (DC) plan for new enlistments using the existing Military Thrift Savings Plan to include the following [13]
 - Service personnel under current DB plan grandfathered
 - Average vesting of 4 years, payout at age 60-65 with flexible payout options
 - Risk adjusted to recognize combat roles and hardship
 - Opportunity of ~\$0.5B reduced future fund liability by FY34 [13]
 - To support sustained affordability through transition, consider:
 - Index payout of retirement benefits to 67 years of age
 - Adjust benefit multiplier to 2.0 (40% of base pay) from present 2.5% (50% of base pay). Benchmarks: private sector 1.1, public and municipal 1.5, fire and police 2.0
 - Adjust High 3 computation to High 5
 - To further accelerate the transition to the DC plan, consider offering the choice for 1-15 year service members of freezing their accrual in the DB plan and opting into the DC plan (financial and conjoint analyses will confirm feasibility)

Estimated Savings: \$254B over 20 years



Closing Remarks

- The Department of Defense is facing one of the world's most demanding business process environments in an increasingly unpredictable environment
- Implementing the DBB recommendations would increase DoD efficiency. Net saving would be ~\$27-37B
- Implementing the DBB recommendations would also increase DoD flexibility and adaptability
- As the Services and Department make tough force structure choices in near term, an inward look at the 'Business of the Department' is important for the future health of our Nation's military capability and the All Volunteer Force
- In Summary: DBB has a two-stage management recommendation
 - **Short-Term:** Get the inefficient money out now! DoD faces up to \$54B annual reductions today!*
 - **Mid/Longer-Term:** Transform DoD for continuous improvement in the new fiscal environment

* Note: Pending Sequester and Budget Control Act implementation



DEFENSE BUSINESS BOARD



Questions?

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These are the final briefing slides as approved by the Defense Business Board in its public meeting held on January 23, 2014. The full DBB report will contain more detailed text which will reflect the totality of the points discussed and any modifications adopted by the Board during their deliberations.

Appendix: Footnotes & References

- 1) “Who Says Elephants Can’t Dance,” Louis V. Gerstner, Oct. 2009
- 2) “Defense Logistics Army Should Track Financial Benefits Realized from its Logistics Modernization Program,” GAO-14-51, Nov. 2013: pp 15
- 3) “DOD Financial Management: Reported Status of Department of Defense’s Enterprise Resource Planning Systems” GAO-12-565R, Mar. 30, 2012: pp 6,10,13
- 4) “Concept of Operations for the DoD Financial Statement Audit Requirement,” RFI-Audit_Services, Defense Finance and Accounting Agency, Sep. 12, 2013
- 5) “Global Logistics Management,” DBB Report, FY11-07
- 6) “DoD Comprehensive Inventory Management Improvement Plan: Monthly In-Progress Review,” Oct. 25, 2013: pp 12, 13, 67
- 7) Meeting with Assistant Secretary of Defense Logistics and Materiel Readiness, Supply Chain Integration, Jan. 2014
- 8) Aon Hewitt, Total Rewards Optimization data, 2013



Appendix: Footnotes & References

- 9) “Retirement Plans Offered by 2013 *Fortune* 100,” Towers Watson, November 14, 2013, Brendan McFarland
- 10) “The Seven Deadly Sins of Defense Spending,” Center for a New American Security, David Barno, Nora Bensahel, Jacob Stokes, Joel Smith and Katherine Kidder, Jun. 2013
- 11) “Costs of the Military Pay and Benefits in the Defense Budget,” Congressional Budget Office, Nov. 2012
- 12) “Report of the Eleventh Quadrennial Review of Military Compensation,” Office of the Under Secretary of Defense for Personnel and Readiness, Jun. 2012
- 13) “Modernizing the Military Retirement System,” DBB Report FY11-05
- 14) “Fiscal Year 2012 Military Retirement Fund Audited Financial Report,” DoD Office of the Actuary, November 6, 2012
- 15) “Valuation of the Military Retirement System: September 30, 2011,” DoD Office of the Actuary, February 2013
- 16) “Rebalancing Military Compensation,” Center for Strategic and Budgetary Assessments, Todd Harrison, 2012



Appendix: Personnel Interviewed

- **Senior DoD Civilian Leadership:**

Robert Hale, Elizabeth McGrath, Christine Wormuth, Teresa McKay, Dr. Daniel Chiu, Dr. Thomas Allen, Paul Brubaker, Richard Robbins, Lisa Disbrow, Dr. Scott Comes, Alan Estevez, Paul Peters, Kevin Scheid, James Hawkins

- **Senior Military Leadership:**

ADM Mark Ferguson, VCNO; GEN Larry Spencer, AF VCOS; GEN John Paxton, ACOM; GEN John Campbell, VCSA; ADM Samuel Locklear, PACOM; LTG Robert Lennox, CAPE; LTG Mark Ramsay, J-8; LTG Robert Ruark, J-4; MG Steven Kwast, USAF QDR; MG Kenneth McKenzie, USMC QDR; RADM Peter Fanta, Dep Dir Resources and Acquisition, J-8

- **Private Industry, Think Tanks, and Others:**

ADM (Ret) Vern Clark; ADM (Ret) Michael Mullen; GEN (Ret) James Cartwright; LTG (Ret) Richard Newton; Gilbert Lamphere, Todd Harrison, Thomas Nides



LIST OF ACRONYMS

TAB C

LIST OF ACRONYMS

AO	Action Officer
AoA	Analysis of Alternatives
BRAC	Base Realignment and Closure
CBO	Congressional Budget Office
CFO	Chief Finance Officer
CIMIP	Comprehensive Inventory Management Improvement Plan
CIO	Chief Information Officer
CivPer	Civilian Personnel
CMRS	Comprehensive Materiel Response Strategy
CONUS	Continental United States
DB	Defined Benefit
DBB	Defense Business Board
DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
DCMO	Deputy Chief Management Officer
DeCA	Defense Commissary Agency
DEPSECDEF	Deputy Secretary of Defense
DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency
DoD	Department of Defense
DSS	Defense Security Service
ERP	Enterprise Resource Planning
FIAR	Financial Improvement and Audit Readiness
FY	Fiscal Year
GAO	Government Accountability Office
GSA	General Services Administration
HR	Human Resource
JLB	Joint Logistics Board
MILDEP	Military Dependent

MilPer	Military Personnel
O&M	Operations and Maintenance
OCONUS	Outside the Continental United States
OEF	Operation Enduring Freedom
OIF	Operation Iraqi Freedom
PMO	Performance Management Office
PSA	Principle Staff Assistant
QDR	Quadrennial Defense Review
RMC	Regular Military Compensation
SBR	Statement of Budgetary Resources
SES	Senior Executive Service
SNO	Strategic Network Optimization
TRANSCOM	United States Transportation Command
VUCA	Volatility, Uncertainty, Complexity and Ambiguity

LIST OF TASK GROUP INTERVIEWS

TAB D

LIST OF INTERVIEWS

Senior DoD Civilian Leadership:

Dr. Thomas Allen

Deputy Director for Studies and Analysis, J8

Paul Brubaker

*Office of the Deputy Chief Management Officer, Director,
Planning and Performance Management*

Dr. Daniel Chiu

Deputy Assistant Secretary of Defense for Strategy

Dr. Scott Comes

Acting Director, Secretary of Defense for Cost Assessment and Program Evaluation

Lisa Disbrow

Vice Director for Force Structure, Resources, and Assessment, J8

Alan Estevez

Principle Deputy, Under Secretary of Defense for Acquisition, Technology, and Logistics

Robert Hale

Under Secretary of Defense (Comptroller) and Chief Financial Officer

James Hawkins

Deputy Director of Strategic Logistics, J4

Elizabeth McGrath

*Deputy Chief Management Officer and the Department's Performance
Improvement Officer*

Teresa McKay

Director, Defense Finance and Accounting Service

Paul Peters

Assistant Secretary of Defense for Logistics and Materiel Readiness

Richard Robbins

*Under Secretary of Defense for Personnel and Readiness, Director,
Total Force Management*

Kevin Scheid

Assistant Deputy Chief Management Officer for Department of Defense

Christine Wormuth

Deputy Under Secretary of Defense for Strategy, Plans and Force Development

Senior Military Leadership:

GEN John Campbell

Vice Chief of Staff Army

ADM Mark Ferguson

Vice Chief of Naval Operations

GEN Larry Spencer

Air Force Vice Chief of Staff

GEN John Paxton

Assistant Commandant Marine Corps

ADM Samuel Locklear

Commander, U.S. Pacific Command

LTG Robert Lennox

Principal Deputy Director, Cost Assessment and Program Evaluation

LTG Mark Ramsay

Director, Force Structure, Resources and Assessment, J8

LTG Robert Ruark

Director of Logistics, J4

RADM Peter Fanta

Deputy Director for Resources and Acquisition, J8

MG Steven Kwast

U.S. Air Force Quadrennial Defense Review

MG Kenneth McKenzie

U.S. Marine Corps Quadrennial Defense Review

Private Industry, Think Tanks, and Others:

ADM (Ret) Vern Clark

former Chief Naval Operations

ADM (Ret) Michael Mullen

former Chairman Joint Chiefs of Staff

GEN (Ret) James Cartwright

former Vice Chairman Joint Chiefs of Staff

LTG (Ret) Richard Newton

former Assistant Vice Chief of Staff and Director Air Force

Gilbert Lamphere

Director CSX

Todd Harrison

Senior Fellow for Defense Budget Studies at the Center for Strategic and Budgetary Assessments

Thomas Nides

Vice Chairman Morgan Stanley

*LIST OF WORK REVIEWED BY
THE TASK GROUP*

TAB E

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