

Statement

Starting Acquisition Programs Well: Budget Issues

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I appreciate the chance to testify today regarding the budgetary aspects of acquisition reform, especially reforms that affect Department of Defense (DoD) weapons programs early in their life cycles. If weapon programs start well, DoD will be more successful in holding down costs and stretching defense budgets. Today I will address what can be done early in a program's life to hold down acquisition costs. I will also discuss the need to control operating and support costs, which I believe should be the next frontier for acquisition reform. I will begin by addressing the consequences of the budgetary turmoil that has adversely affected DoD weapons programs and all other defense activities.

Ending Budgetary Turmoil

Since 2010 DoD and many other federal agencies have experienced near-constant budgetary turmoil. The large and sudden sequester cuts of 2013, and the government shutdown in that same year, constitute the best known events. Other events are less well known but contributed to disruption. They include the repeated requirement to formulate plans to shut down the government, creating two budgets for the same year because of uncertainty about the ultimate size of the appropriation, and a steady diet of continuing resolutions including two that lasted for six months.

Some aspects of this budgetary turmoil harm acquisition programs disproportionately. For example, when operating under continuing resolutions, DoD cannot generally undertake any contracting actions related to new-start programs, and the Department must often delay other contracting actions because of uncertainty about the eventual size and composition of budgets. These delays compress many contracting actions into part of the year, which makes it harder for them to be successful. Large, rapid cuts in defense budgets also tend to harm acquisition programs disproportionately because of the difficulty of cutting forces and people costs quickly. In 2013, for example, DoD experienced the largest one-year cut in defense funding since the Korean War. In 2013 base-budget funding for acquisition activities absorbed about 45 percent of the budget cuts even though acquisition funding makes up only about 30 percent of the defense budget.

In most cases budgetary turmoil harms all programs in the Defense Department, not just acquisition efforts. Budgetary turmoil wastes money, siphoning funds away from more useful purposes. Because of the shutdown furloughs in 2013, for example, DoD wasted about \$400 million in civilian personnel costs. Budgetary turmoil also consumes substantial amounts of the time of thousands of DoD managers, reducing the time they can spend on long-term improvements such as acquisition reform.

Of particular concern are the effects of budgetary turmoil on the morale of DoD's workers, especially its civilian workers including many who work in acquisition. Poll data suggest that, despite a recent uptick, the morale of government civilian employees has declined by about 11 percent since the budgetary turmoil began in 2010. The two furloughs in 2013 contributed to this decline, as did three years of civilian pay freezes. Some in Congress have also contributed to the problem through their criticism of government civilian employees. Employees perform best when they feel that their employer values their work and treats them well. After the events of the past five years, fewer DoD employees appear to have those feelings about their employer.

If DoD is to succeed in improving the performance of acquisition and other programs, Congress and the Administration must end the budgetary turmoil. The Bipartisan Budget Act of 2015 made a start by providing a predictable budget for fiscal year 2017. But the country needs a broader budget deal that addresses all aspects of federal spending and revenues, not just spending on discretionary programs like defense. That agreement needs to end the threat of meat-axe sequester cuts and provide reasonable levels of funding for the Department of Defense and other federal agencies, while also taking into account deficit concerns. Hopefully a broad budget agreement will be a priority for the next Administration.

Slowing Growth in Acquisition Costs

Let me turn now to ways to hold down acquisition costs by starting programs well. Unit acquisition costs for defense weapons have grown substantially for many decades. I call it the "rule of 2 to 3". Unit acquisition costs of new generations of weapons are often 2 to 3 times

larger than those for the preceding generation, even after adjustment for inflation. This rule still appears to be holding for some recent major acquisitions. The F-35 aircraft, for example, seems likely to have an acquisition unit cost several times that of the F-16, the plane it will replace in largest numbers. The Ford-class aircraft carrier also appears to be following the rule.

Some of these higher acquisition costs led to improvements in capability that were needed to keep up with potential adversaries. Stealth, for example, has been a game changer in military terms. Computerization is necessary to stay ahead of potential adversaries.

However, higher unit acquisition costs – especially combined with increases in operating and support costs that I will address next – force the military to reduce the size of its forces unless overall defense funding rises sharply. To avoid continued force cuts, it is important that, early in the life of a weapon system, DoD weigh costs against capability in setting the baseline costs for weapon systems and then avoid increases above those baselines.

In recent years the Defense Department has made significant and commendable progress in avoiding growth above baseline costs. In its September 2015 report on the performance of the defense acquisition system, DoD assesses growth in the cost for major defense acquisition program compared with baselines set at milestone B of the acquisition process. That growth has declined significantly since the 1990s. In recent years there has also been a decline in the fraction of major programs with Nunn-McCurdy breaches not related to quantity changes and an overall decline in the fraction with critical breaches. (The Nunn-McCurdy legislation requires a report to Congress when growth in the costs of a weapons program exceeds thresholds established in the law.) The September 2015 report also highlights improvements in other aspects of acquisition performance, such as cycle times, that significantly influence budgets.

While avoiding growth above baseline costs is important, the Department also needs to establish baseline costs that are consistent both with likely future budgets and threats to national security. Establishing reasonable baseline costs requires difficult tradeoffs between costs and the requirements for weapons that, in many cases, will be in the DoD's inventory for

decades. These tradeoffs need to occur early in a program's life, when major changes can be made in a weapon's design. Starting programs well demands these tradeoffs, difficult though they are.

I will defer to other experts regarding the best nature of the tradeoffs and how to make them stick. However, based on decades of experience working around defense policy and budget issues, I am convinced that the Department and Congress need mechanisms for highlighting the results of these tradeoffs. To that end, I am pleased that the Department of Defense is moving forward with affordability caps. As described in the September 2015 report, these caps will apply to both procurement and sustainment costs and so will address budget issues over the entire life cycle of weapons. If affordability constraints cannot be met – even after aggressive cost control efforts – the DoD report states that technical requirements, schedule, and required quantities must be revisited.

According to the September 2015 report, affordability caps have been established for 29 major defense acquisition programs including some programs that have not yet reached milestone B. Thus about 70 percent of the major defense acquisition programs have been assigned an affordability constraint. The military services have established organizations to help establish and monitor the caps.

I have focused so far on DoD's efforts to improve acquisition and control costs. Congress has also sought to improve the acquisition program, most recently through a series of reform initiatives embodied in the defense authorization legislation for fiscal year 2016. Some of the initiatives in this legislation should help hold down costs. For example, the legislation mandates increased involvement by the service chiefs in setting requirements. Tradeoffs with requirements are key to limiting cost growth, a goal that will certainly be on the minds of the chiefs and their staffs as they implement this provision. The legislation requires an acquisition strategy for all major acquisition programs, a provision that can help limit cost growth by providing a vehicle for assessing costs as they relate to budgets. The legislation also modifies the authorities of the Configuration Steering Boards, which are important in ensuring – among

other things -- that affordability caps are enforced in a meaningful manner. Finally, the legislation requires that the service chiefs submit a report on how to streamline and better integrate their services' processes relating to weapons requirements, acquisition, and budget.

The authorization legislation also seeks to improve DoD's access to commercial products, services, and solutions in part to help make available more innovative products from the commercial sector. More use of commercial products may also help hold down costs. The authorization legislation also seeks to streamline acquisition procedures and provides waiver authorities designed to facilitate faster and cheaper acquisition, especially for weapons capabilities that are of vital interest to the United States.

In addition to altering laws, Congress can play a key role in improving acquisition by shining a spotlight on problem areas. Based on my own experience in DoD, I know that constructive Congressional hearings focus senior-leader attention on broader issues, which is important because the frenetic pace of activity in the Department sometimes make it hard for leaders to focus on big-picture issues. I would particularly urge that this Committee and other defense committees use hearings to monitor DoD's progress with the affordability caps I just described.

Controlling Operating and Support Costs: the Next Frontier

The affordability caps deal not just with acquisition costs but also with operating and support costs (sometimes called sustainment costs). From a budget standpoint, controlling the growth in defense operating and support (O&S) costs represents a critical challenge. O&S costs make up about two thirds of today's defense budget. These costs also typically comprise more than half of the total cost of buying and operating a weapon over its life cycle. Operating costs are likely to become even more important to budgetary success as DoD keeps weapons in its inventory longer, increasing the period when the Department must pay to operate them. For all these reasons, I believe that controlling O&S costs should be the next frontier for acquisition reform.

In recent years O&S costs have grown sharply even as forces declined in size. After adjustment for inflation, O&S costs have grown by about 20 percent since fiscal year 2000. (These calculations exclude wartime or OCO costs.) At the same time, military force size – as measured by the number of active-duty military personnel – has *declined* by about 4 percent. This same pattern occurs in all the military departments. Nor is this trend limited to years since 2000; even more startling trends have occurred over at least the past 50 years.

DoD must find ways to control growth in costs for both O&S and acquisition costs. If it does not, then military forces will continue to get smaller unless defense funding grows sharply. Yet many military leaders believe that today's force sizes are already at the minimum required to handle global threats at acceptable levels of risk.

So what is causing O&S costs to grow and what can DoD do about it? For purposes of this testimony, I have defined operating and support (O&S) costs as funding in the appropriations for operation and maintenance and military personnel. That means that O&S costs pay for all the costs to operate a modern military, from fuel to military health care and much in between.

Some of the O&S growth is not directly related to operating military weapons. Increases in military health care costs and growth in costs for military compensation have caused part of the rise in O&S costs, as have many other factors. DoD has sought to slow the growth in O&S costs not related to weapons. With Congressional help, the Department reduced military health care provider costs, especially those related to pharmaceuticals. Congress has permitted DoD to slow the growth in military compensation in ways that, so far, have allowed the Department to meet recruiting and retention goals. Last year the Congress led efforts to reform the military retirement system in order to modernize the system and slow growth in costs. DoD has implemented initiatives to achieve efficiencies and eliminate lower-priority programs in order to control growth in O&S costs.

But more effort is needed. That is why I am pleased that key members of Congress have stated that they will tackle military health care reform this year, seeking to improve service while also slowing the growth in costs. Congress also needs to permit DoD to close unneeded military facilities. I know that this is a politically difficult task, but closing unneeded facilities will cut

back on the demand for civilian employees and reduce O&S costs. DoD, for its part, needs to continue efforts to seek efficiencies that hold down operating costs.

A substantial part of the growth in O&S costs appears to be directly related to weapons. Publically available data do not permit the identification of military personnel costs directly associated with the operation of military weapons and forces. But budget documents do identify the portion of the operation and maintenance (O&M) appropriation that finances most other costs used to operate forces. These O&M operating-force costs (which include most funds in Budget Activity 1 of the O&M appropriation) exclude military health care and other expenses not directly related to operating military weapons and forces.

Since fiscal year 2000 O&M operating-force costs (again adjusted for inflation and excluding wartime costs) have grown by about 35 percent, substantially exceeding the 20 percent growth that occurred in O&M as a whole. Some of this growth reflects improvements in weapon capabilities needed to meet evolving threats. Stealth, computerization, and overall complexity all influence the growth. As with acquisition costs, DoD needs to start programs well by trading off requirements against O&S costs.

While DoD has devoted much effort to controlling acquisition costs, it has not yet paid as much attention to O&S costs. The new affordability caps, which include O&S costs, provide a vehicle for increased scrutiny. DoD's September 2015 report states that weapon programs will be cancelled if affordability constraints cannot be met even after aggressive efforts such as cost control and changes in schedule and requirements. Cancelling a program due to unacceptably high O&S costs, or even considering such an action, would send a message that this budget behemoth must be taken seriously.

I don't want to suggest that controlling O&S costs is easy. It is difficult to predict future O&S costs, especially early in the life of a program when major tradeoffs can be considered. But difficult doesn't mean impossible. The Department needs to invest in better models that can be used early in the life of a program to help managers understand the effects of design changes on future O&S costs. The Department also needs to invest more in understanding what determines weapon operating costs and what can be done to hold down these expenses.

Commercial airlines, for example, trade off operating costs and performance during aircraft design. DoD should consider the same tradeoffs, which must occur early in a program's life. DoD might also want to look at O&S costs not just for an individual weapon system, but for a family of similar weapons. That would permit the Department to consider holding down costs by replacing older systems with a smaller number of new ones.

Congress can also play a role in slowing the growth of operating costs. For example, Congress can use hearings to focus attention on these costs. As I mentioned earlier, I would especially urge that this Committee and other defense committees use hearings to monitor DoD's progress in implementing the new affordability caps. Those hearings should focus on the O&S portion of costs.

Congress can also use reporting requirements to shine a spotlight on O&S costs. The Nunn-McCurdy legislation requires reporting on weapon programs that breach thresholds for growth in unit acquisition costs, thereby focusing senior-leader attention on these problem programs. It is time to consider similar reporting requirements associated with growth in O&S costs.

In sum, program managers supervising new weapon programs have much on their management plates. Tradeoffs between requirements and weapon costs represent one of their more important tasks, with tradeoffs between requirements and operating costs being particularly important from a budgetary standpoint. I believe that efforts to control weapon operating costs should be the next frontier for acquisition reform.