



Statement of
Scott Rutherford
Senior Partner, McKinsey & Company
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Chairman Chaffetz, Ranking Member Cummings, and Members of the Committee, I am pleased to appear before you today to discuss McKinsey's work for the Department of Defense, and our work with the Department's Deputy Chief Management Officer to evaluate the Department's spending on core business processes.

In the fall of 2014, McKinsey was engaged by the Department of Defense to conduct a comprehensive assessment of the Department's spending in six core business areas. From the fall of 2014 through the spring of 2015, a team of McKinsey consultants developed a detailed compilation of the Department's spending in these areas, assessed the overall potential for cost savings in these areas, and conducted two targeted proofs of concept to demonstrate an approach to achieving savings in services contracts. We are very proud of this work, and we continue to believe that the Department of Defense and the public sector can benefit from McKinsey's unique skills, developed through decades of private sector experiences, in evaluating organizational efficiencies with a goal of reducing costs.

Our work with the Department began with the development of a cost "baseline" that assembled data on spending across the entire Department in six important areas: human resource management; healthcare management; financial flow management; logistics and supply chain; acquisitions and procurement; and real property management. The McKinsey baseline was, we believe, a more comprehensive look at spending in these areas than previously existed.

The McKinsey baseline has been important to the Department's cost cutting efforts in a number of important ways:

First, the Deputy Chief Management Officer shared McKinsey's baseline with the Defense Business Board, and the baseline was used by the Board in its own analysis and report, released in January 2015, which estimated \$125 billion in potential cost savings over five years. Importantly, although McKinsey's baseline was used by the Board as the baseline for its effort, the projections, assumptions, and analysis related to potential cost savings are those of the Board, not McKinsey.

Second, under the Deputy Chief Management Officer project, McKinsey's work continued into the areas of "benchmarking," to compare the Department to other large enterprises and identify potential areas for savings, and "roughsizing," where we began the processes of estimating the savings that might be achieved. At the end of that process, which

extended to May of 2015, McKinsey's roughsizing analysis estimated that the Department could achieve savings between \$62 billion and \$84 billion over the five years between 2015 and 2020.

Third, we understand, from informal conversations with the Department since concluding our work in 2015, that the Department has used our baseline, benchmarks, and cost savings estimates to implement changes that have put them on the path to generating actual cost savings.

Mr. Chairman, I would like to focus for a moment on the different cost savings estimated by the Defense Business Board in its January 2015 report, and the cost savings estimated by McKinsey in its work delivered to the Deputy Chief Management Officer in May 2015. Given that both estimates were based on the McKinsey baseline, it may seem strange that the Defense Business Board estimated \$125 billion in savings over five years, and McKinsey estimated between \$62 billion and \$84 billion over five years.

There are two primary factors that underlie this difference:

First, from reviewing the Defense Business Board's report, I understand that its cost savings estimates were based on metrics of productivity improvements that have been observed and achieved in past cost savings efforts, primarily in the private sector. This is understandable and appropriate given the Board's role – it was created to give the Department advice that reflects a private sector perspective on effective best business practices. Although McKinsey's process similarly included benchmarking against existing metrics, we had the additional benefit of several months more work within the Department, where we performed additional analytical work that informed our projections, particularly with respect to the pace of achievable change.

Second, specifically regarding that pace of change, the differences between the Board's projection and McKinsey's projection are largely driven by the projected pace of change. Because both projections encompass a five year period, a total savings projection is highly sensitive to savings predicted in the early years. For example, if a projection includes an estimate of a large saving in the first year – which would accrue again in year two, three, four, and five because it has been achieved – the total cumulative savings over the five year period can be significantly higher than if the estimated initial savings are more modest.

Finally, it is important to distinguish between the cumulative cost savings and the reduction to the amount that the Department spends on these costs in any given year. McKinsey's projection of \$62 billion in savings, for example, was based on a projected reduction in annual spending of about \$4 billion each year. Over five years, the annual spending in that scenario would reduce from \$134 billion (in 2015) to \$113 billion (in 2020).

McKinsey & Company

McKinsey is a global firm that, for almost 100 years, has helped leading businesses, nonprofits, governments, and others achieve their most important goals. We have more than 10,000 consultants and experts, along with about 2,000 research and information specialists working across the globe. Our people include doctors, business managers, engineers, research scientists, civil servants, and entrepreneurs. We focus on high-value consulting, supporting organizations' most high-value, high-risk, and complex priorities for organizational change.

McKinsey takes a team-based approach to our projects. When we are engaged, we identify a team to work on the project and identify an estimated timeframe for completion. In addition to the teams assigned to the project and the partners leading the effort, our clients have access to our worldwide network of experts and support staff and to our proprietary knowledge, tools, and analyses on which we invest more than \$400 million annually. McKinsey contracts with clients for a firm fixed price – we do not bill by the hour.

McKinsey is recognized for its leadership and expertise. We are thought leaders in both the public and private sector. Our consultants often help organizations identify problems and provide input on options for solving them, including sharing best practices and possible approaches. We also frequently publicize our views. For half a century, we have published the McKinsey Quarterly, which sets the agenda for top global managers. We also publish materials specific to key sectors, such as McKinsey on Government, McKinsey on Defense, and others. We operate the McKinsey Global Institute, a business and economics think tank, and McKinsey Center for Government, a global hub for research, collaboration, and innovation in government performance.

McKinsey has served the U.S. government for many years, and we founded our firm's U.S. government-serving entity about a decade ago, specifically focused on serving the U.S. public sector. As with our private clients, our public sector practice focuses on solving the big problems. In serving our public sector clients, we use our proprietary research, tools, and approaches as well. For example, the McKinsey Center for Government performs independent research on management in the public sector that we can apply in our public sector work.

McKinsey's Approach to Cost Savings Studies

One of McKinsey's key strengths is conducting cost savings studies. For both private and public sector clients, we apply a series of phases for cost savings studies. A McKinsey cost savings project can encompass some or all of the phases, as determined by the client. Our contract with the Defense Department covered phases one through three.

Phase one is "baselining." The baseline is the starting point for a cost savings analysis. McKinsey works closely with the client and the client's data to determine the types and amounts of costs that currently exist. Baselining includes analyzing the costs, resources, and assets that are responsible for delivering a particular function or capability. For some clients baselining can be simple and straightforward; for others, such as the Department of Defense, it is highly complex and more challenging.

Phase two is "benchmarking." In benchmarking, McKinsey compares the client's efficiency and effectiveness to other relevant businesses or industries, to McKinsey's view of the best practices, and the client's internal organizations. McKinsey's proprietary processes and databases add significant value because they reflect years of institutional knowledge and experiences. Frequently, McKinsey's broader view across a variety of industries is unique and not replicable from other sources.

Phase three is "roughsizing." In this phase, McKinsey develops a high level estimate of the savings that may be possible. In broad strokes, this estimate reflects the difference between

the existing actual costs (quantified in the baseline) and the best practices in the applicable area or industry (developed in the benchmarks). Roughsizing results in high level estimated savings, and it gives an organization the ability to quantify the potential and prioritize the actual cost savings initiatives to be pursued. Roughsizing may also include conducting some targeted proofs of concept to validate the opportunities and refine the savings estimate.

Phases four and five, which the Department of Defense did not ask McKinsey to perform (as it was not in the contract), would have involved the development of a specific set of recommendations of cost savings initiatives to pursue to achieve the estimated savings, and the implementation of those initiatives to achieve actual cost savings, respectively.

Contract with the Department of Defense

In September 2014, McKinsey and Ryan Consulting entered into discussions about subcontracting under Ryan on a project of the Department of Defense's Deputy Chief Management Officer to conduct a core business process cost evaluation.

Earlier, in August 2014, members of the Defense Business Board who were familiar with McKinsey's expertise in cost savings studies had asked McKinsey for perspectives on conducting a cost savings analysis of the Department's core business activities. McKinsey provided perspectives on best practices in the industry concerning cost savings studies.

McKinsey's work with the Department of Defense provided for phases one and two (baselining and benchmarking) and an option for phase three (roughsizing). McKinsey performed this contract, with Ryan as the project manager, using our GSA-approved MOBIS rates (\$2,734,227.05 for phases one and two, and \$5,693,323.45 for phase 3, following the exercise of the option).

McKinsey conducted phase one from approximately October 2014 to January 2015. McKinsey delivered its final results for this phase in January 2015, identifying a baseline of more than \$130 billion in annual costs, including \$40 billion in contracted services, \$45 billion in civilian salaries, \$29 billion in military salaries, \$11 billion in contracted goods, and \$7 billion in information technology. This baseline included costs associated with more than 260,000 contractors and about 450,000 civilians.

McKinsey conducted phase two, which developed the benchmarks, primarily in January 2015. Benchmarking an institution as unique as the Department of Defense is very challenging. In some cases, McKinsey recommended that the Department benchmark against its own productivity metrics, particularly in areas where no private sector comparison is possible. Additionally, McKinsey excluded some portions of the baseline from the benchmarking because we could find no reasonable analogs to those spend categories in the public or private sectors.

In February 2015, the Department exercised the option for phase three, and McKinsey began work on the roughsizing process to estimate potential savings. McKinsey delivered the results of this phase in May 2015, which estimated potential savings in a range of \$62 billion to \$84 billion over five years. McKinsey also provided two targeted proofs of concept to demonstrate the approach and offered perspectives on approaches to further phases designed to achieve the potential savings. The Department did not extend the contract for these purposes.

Defense Business Board

In the early parts of McKinsey's work for the Department of Defense under the contract, the Deputy Chief Management Officer requested that McKinsey keep the Defense Business Board apprised of our baselining efforts. At the request of the Secretary of Defense, the Board was conducting its own cost savings study. We understand that the results of McKinsey's development of a baseline was shared with the Board, and the McKinsey baseline is thus also the baseline underlying the Board's report on projected savings, which it issued in January 2015.

As noted in the Board's report, the Board interviewed dozens of current or former military leaders, civilian leaders, and others familiar with cost savings efforts, such as private sector leaders, academics, and think tanks. In this context, McKinsey also provided the Board with its perspectives on best practices and advice concerning cost savings models.

The Board's report reflected its own analysis and projections regarding the potential for cost savings. The Board delivered its report in January 2015, and McKinsey continued with phases two and three of our work for the Department through May of 2015.

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Mr. Chairman, thank you for the opportunity to appear before you today, and I would be happy to answer any questions that you or the Committee Members have for me.