

## DEFENSE BUSINESS BOARD



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

January 23, 2014

# 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
- Interviewed 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

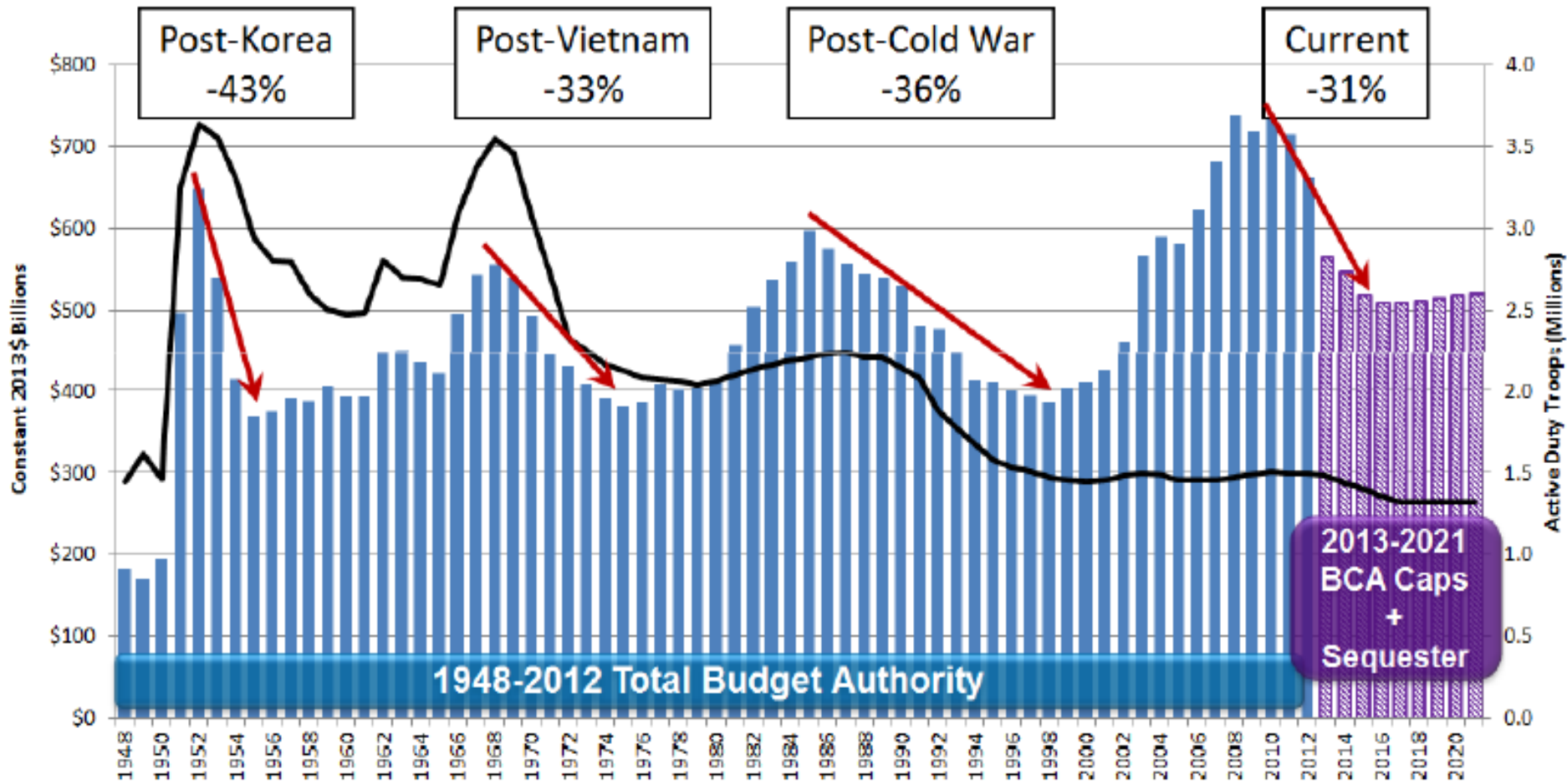
Note: DoD delays and furloughs have impacted the timeliness of this study as it applies to the QDR 2014 report

\* Note: Appendix lists officials interviewed



# Major Trends

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



Source: CSIS, Feb 2013; CBO estimates

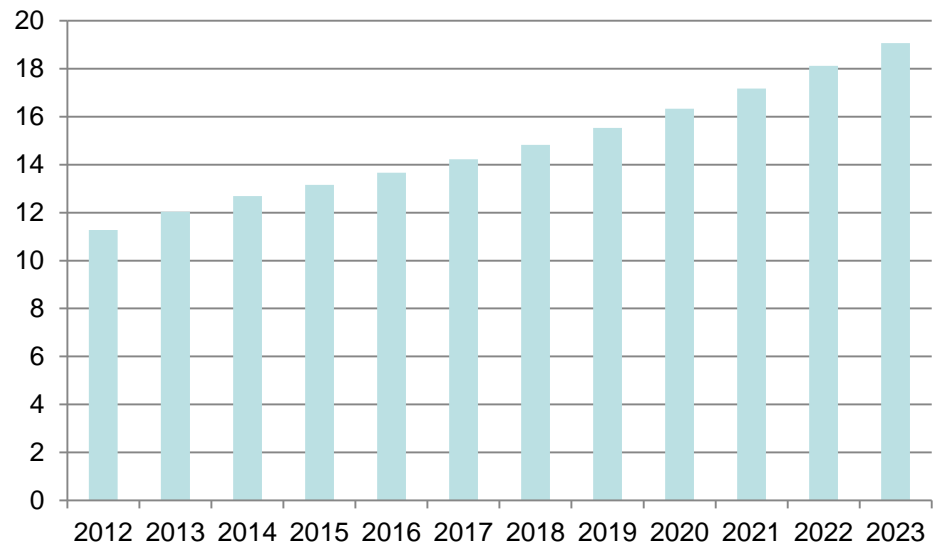
**Future budget constraints will impact DoD**

# 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

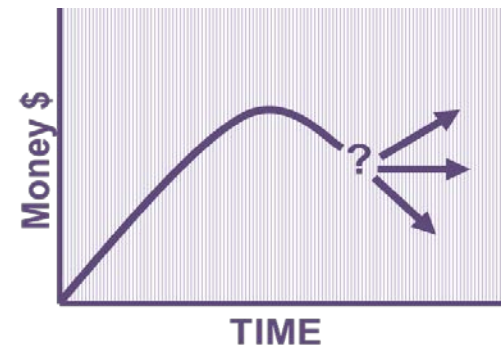
**U.S. Debt growth will impact future DoD budgets**



# 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	▪ \$4-6B savings and increased flexibility
2) Logistics and Supply Chain	▪ \$18-23B savings and increased readiness
3) Human Capital Management	▪ 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"> <li>▪ Enables quick response to changing conditions with more certainty</li> </ul>
Non-financial executives spend 20-30% of their time on financial management issues	<ul style="list-style-type: none"> <li>▪ Unified management team focused on costs</li> </ul>
Integration of Business systems using Enterprise Resource Planning (ERP), middleware, open source tools	<ul style="list-style-type: none"> <li>▪ Saves 10-25% of annual operating costs</li> <li>▪ Typically replaces redundant, outdated, and expensive systems</li> </ul>
Financial transparency to organizational leadership and investing community	<ul style="list-style-type: none"> <li>▪ Executives held accountable for financial goals</li> <li>▪ Financial goals and objectives are shared across leadership teams</li> <li>▪ Financial statements are auditable and open at public companies</li> </ul>
Sustaining a culture of cost management – not an initiative, a continual process	<ul style="list-style-type: none"> <li>▪ Can reduce overhead by 5%</li> <li>▪ Better informed management decisions</li> </ul>

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



# Logistics and Supply Chain Management

## Best Business Practices

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

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 through the first use of computerized traffic control



# Logistics and Supply Chain Management

## Scope of DoD Logistics



### 171.2 Billion Annual Budget (FY12)

- \$79.5 billion in maintenance
- \$67.6 billion in supply
- \$24.2 billion in transportation

### Operational Resources (FY12)

- 100,000 suppliers
- 92,000+ requisitions per day
- \$96.4 billion inventory/4.6 million items

### \$608.3 Billion in Assets (FY12)

- 600 ships
- 16,000 aircrafts
- 40,300 combat vehicles
- 367,300 ground vehicles

### Logistics Operating Locations (FY12)

- 18 maintenance depots
- 25 distribution depots (global)
- 49,500+ customer sites
- Worldwide air and seaports

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



# 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

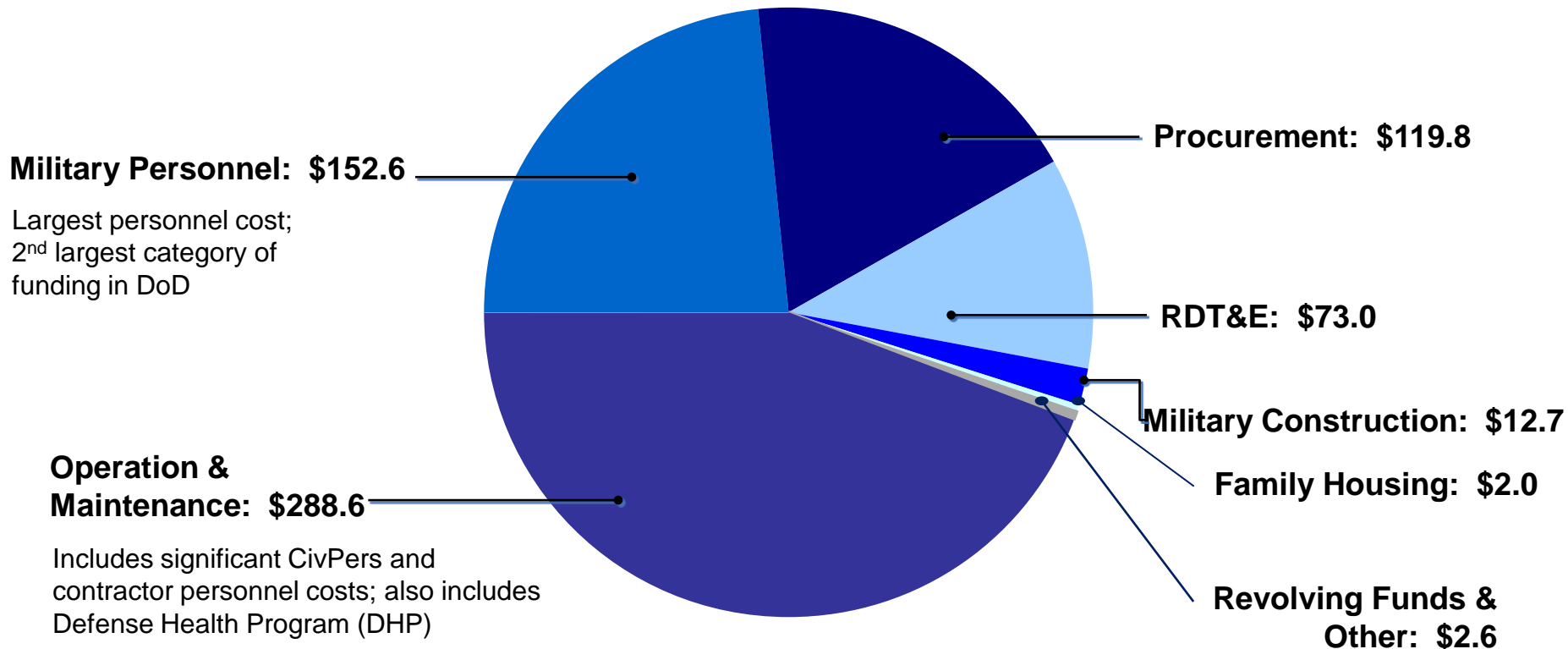
- Through process re-engineering, strong cultural interventions, and change management, layers reduced from 12 to 6 and spans of control increased from 3 to 10
- Positioned company to take advantage of new portfolio and emerging market opportunities



# 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

#### Joint Staff

- Chairman
- Vice Chairman
- Director, Joint Staff
- Vice Director
- Director, J-#
- Vice Director
- Deputy Director
- Regional/Subject Officer

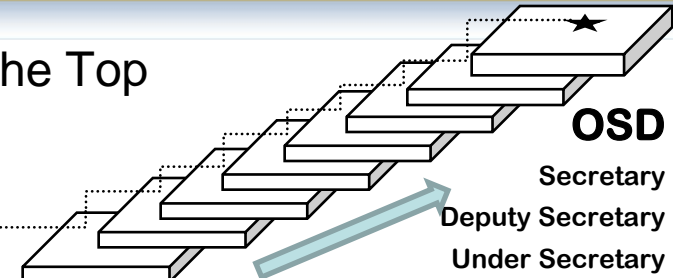
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#### Service Secretariat

- Secretary
- Under Secretary
- Assistant Secretary
- Principal Deputy Assistant Secretary
- Deputy Assistant Secretary
- Director
- Action Officer



#### OSD

- Secretary
- Deputy Secretary
- Under Secretary
- Principal Deputy Under Secretary
- Assistant Secretary
- Principal Deputy Assistant Secretary
- Deputy Assistant Secretary
- Office Director
- Action Officer

#### Service Military Staff

- Chief of Staff
- Vice Chief of Staff
- Assistant Vice Chief of Staff
- Director of Service Staff
- Deputy Chief of Staff
- Assistant Deputy Chief of Staff
- Division Chief
- Office Chief
- Action Officer

Start with AO

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"> <li>▪ Supports delivery of high performance and rewards for results</li> </ul>
<p>Understanding compensation and benefit value through the “lens” of the employee using Conjoint Analysis</p>	<ul style="list-style-type: none"> <li>▪ 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]</li> <li>▪ 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</li> </ul>



# 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"> <li>▪ Reduces volatility of existing liabilities.</li> <li>▪ 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</li> </ul>
<p>Changes to business strategy, and/or organization structures accompanied by targeted changes to the compensation system</p>	<ul style="list-style-type: none"> <li>▪ Promotes greater organizational alignment and efficiencies</li> </ul>
<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"> <li>▪ Incentivizes and rewards strong performers while providing valuable feedback to lower performing employees</li> </ul>
<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"> <li>▪ Increases employee satisfaction and promotes efficiencies</li> <li>▪ Allows for non-cash benefits to be incorporated into pay/benefits spectrum</li> </ul>



# 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 <sup>[14]</sup>
- As of FY2011, the MRF pension liability is ~70% unfunded <sup>[15]</sup>
  - Reduction of forces will slow future growth
- A recent statistically limited conjoint analysis <sup>[16]</sup> 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."*

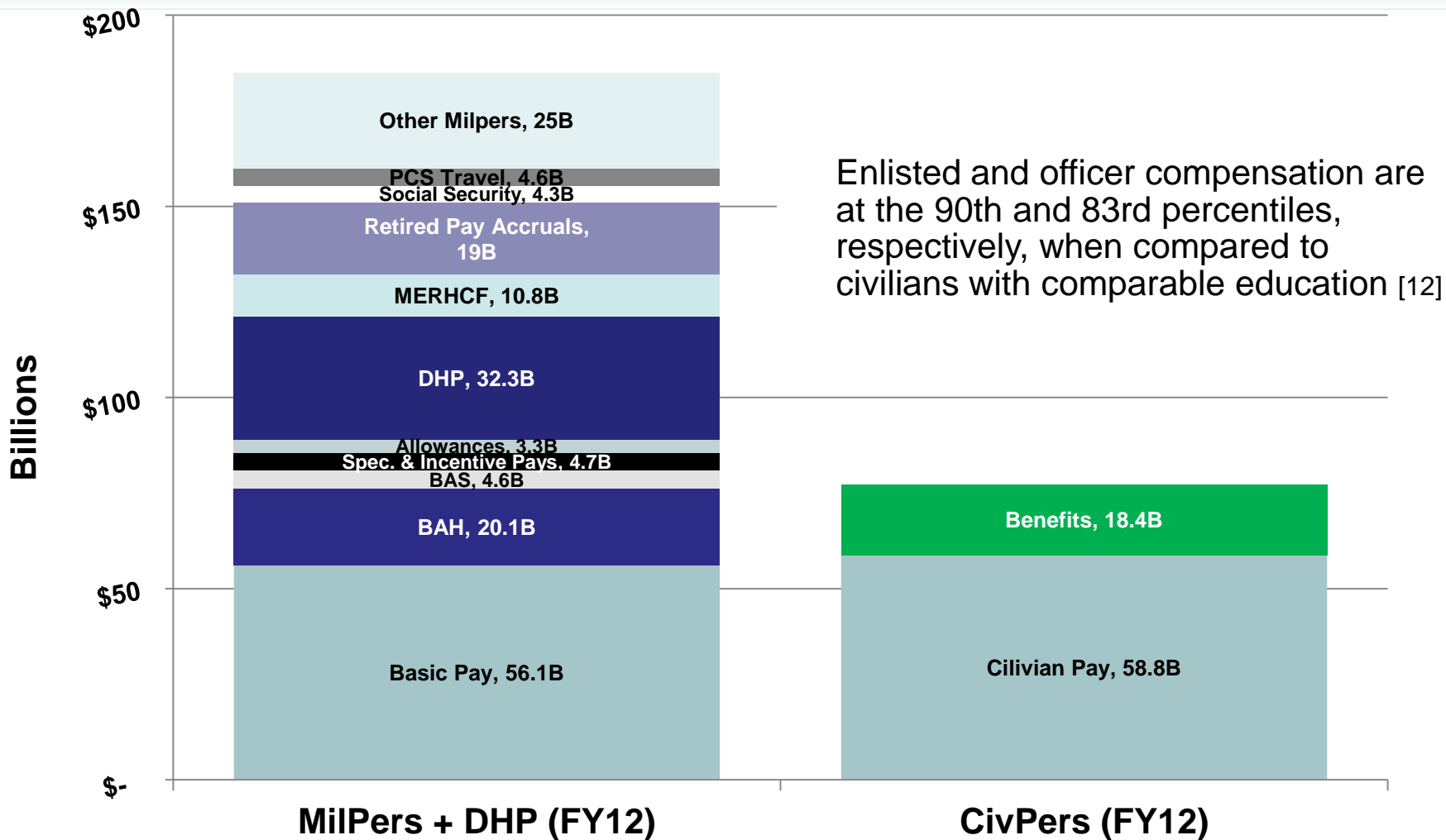
Thomas Gates, Chair of the All-Volunteer Force Study, February, 1970





# 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?

### DEFENSE BUSINESS BOARD

*Business Excellence In Defense of the Nation*

# 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

