



**STRATEGY
RESEARCH
PROJECT**

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**PRIVATIZATION OF DEPOT-LEVEL MAINTENANCE:
ACHIEVING SIGNIFICANT SAVINGS WHILE
MAINTAINING READINESS**

BY

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ABSTRACT

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The end of the cold war led to significant reductions in defense spending and corresponding reductions in force structure. However, constrained budgets created a severe lack of funding for equipment modernization. A major hurdle facing DoD is how to create resources needed to modernize the force, while maintaining readiness. The support structure, which has not declined in proportion to force structure, is one source of funding. Maintenance depots constitute a major component of the support structure. The central theme of this study is to analyze if DoD can create significant savings by privatizing more depot level maintenance and simultaneously balance readiness, sustainment, and private sector reliability. This study concludes that greater privatization increases savings, which DoD can use to modernize and sustain the force.

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The demise of the cold war and the belief that the only threats over the horizon are low to mid-intensity conflicts have led to significant reductions in post cold war defense spending and large reductions in force structure. However the down side to the cold war and growing budget constraints is the severe lack of funding for equipment modernization which has declined steadily in recent years.

In light of reduced funding, a major challenge facing DOD is how to free up needed resources required to modernize equipment, while simultaneously maintaining readiness and responsiveness to war fighting and regional contingencies. In constant FY96 dollars, procurement fell from \$126 billion in FY85 to only \$39 billion in FY96--a reduction of 69 percent.¹ Both the Secretary of Defense and the Chairman of the Joint Chiefs of Staff support increased funding for new equipment upgrades. They have stated on numerous occasions that funding levels for modernization must increase substantially if DOD plans to acquire the new weapon systems required for the 21st century.

In contrast, the defense support infrastructure, which is a critical component of our nation's industrial base, has not declined in proportion to force structure. The Department of Defense continues to maintain vast, in-house support infrastructures to house, train, equip and manage its fighting

force.² The Defense Department currently spends well over 55 percent of its total budget on support and infrastructure, excluding that in the battlefield arena.³ This infrastructure consumes a large and growing share of total DOD resources.⁴

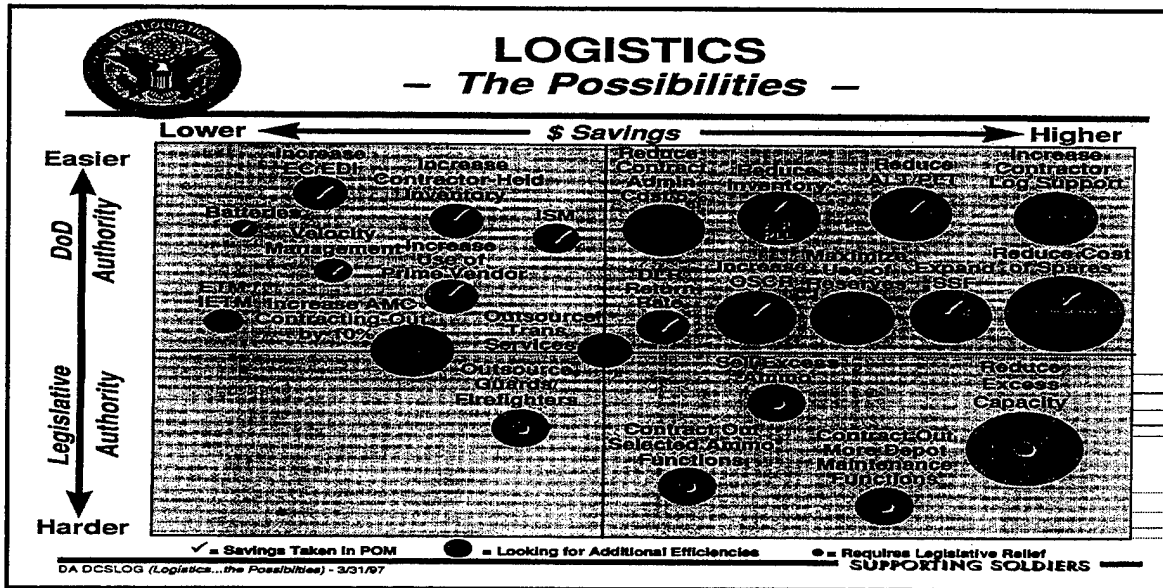
A major component of the support structure is the network of maintenance depots owned by the services to provide maintenance support. The central theme of this study is analyze if the Department of Defense can create significant savings through increased privatization of depot level maintenance, while maintaining an appropriate balance between readiness, sustainment, and private sector reliability. This study will analyze privatization and outsourcing issues central to the current depot maintenance structure. DoD analyzed management techniques applied to its support functions to improve support structure efficiency and to find money for equipment modernization. DoD concluded that certain functions were ripe for the application of commercial business practices and could potentially save millions of dollars.

Two commercial practices popular in industry are outsourcing and privatization. Outsourcing involves the transfer of support functions previously performed in-house to an outside service provider.⁵ Privatization is a type of outsourcing involving the

transfer of government assets (depots, data centers, etc.) to the private sector.⁶ The Defense Science Board Task Force on Depot Maintenance Management supports outsourcing. Its August, 1996 report on outsourcing and privatization states: "an aggressive DoD outsourcing initiative could generate savings of up to \$7 to \$12 billion annually by fiscal year 2002 (FY02) -- resources which then would be available for equipment modernization".⁷

It is imperative that an equitable distribution of workload occur between the public and private sectors in order to meet the logistical needs of combatant commanders. There are several issues which affect workload balance between the public and private sectors. These issues include workload policy, congressional guidance, and competition policy.

Where DoD has the authority to implement changes, savings are much easier to achieve. This is not true for efficiencies that are subject to Congressional management. As the chart below illustrates, several issues affecting greater savings through outsourcing are subject to legislative authority which is often times restrictive in nature and difficult to change.



So, therefore the degree to which DoD is successful in this endeavor is a function of both internal efforts and external efforts involving numerous second and third order effects players. However, before these issues are addressed any further, it is important to review how depots evolved into such massive industrial organizations.

Background: How Our Nation's Depots Evolved

During World War II, at a time when the Army was purchasing massive quantities of new, modernized, and more sophisticated weapon systems, DoD met the emerging requirement for depot level support largely by the creation of government-owned and operated depots.⁸ The government later expanded depot maintenance capability to meet the demands of the cold war requirements. This expansion was highlighted during a recent speech given by

the former Joint Chiefs Chairman, Retired Gen. John W. Vessey Jr., who pointed out that in the middle of the 20th Century, the Army had to create nearly the "mirror image of a large industrial economy in order to take military force to less-developed or war-damaged parts of the world".⁹ The overview in the following section illustrates how our depots functioned in the post cold war era.

Maintenance Depots: An Overview

With the "Fall of the Wall", the all-out war scenario was no longer a basis for planning, and a period of geopolitical and fiscal retrenchment began.¹⁰ Depots serve as a direct link to the industrial base for units stationed around the world and are in essence, an essential part of preserving our national defense. Depot-level maintenance and repair entails repair, rebuilding, and major overhaul of weapon systems (e.g., ships, tanks, and aircraft) parts assemblies and subassemblies.¹¹ DoD depots currently employ 89,000 Federal Government workers ranging from highly trained technicians and skilled artisans to engineers and top level managers.¹²

The Military Services currently operate 30 major depot maintenance facilities (some of which are in the process of being closed). Additionally, DoD uses in excess of 1,300 U.S and

foreign commercial firms to support its depot maintenance requirements. Currently, the Department of Defense spends about \$13 billion annually for depot-level maintenance and repair performed in both the public and private sectors.¹³

The Army spends about \$1.3 billion annually on depot maintenance activities.¹⁴ Army maintenance depots have primary responsibility for the maintenance, overhaul, and repair of certain major weapon systems and their components, to include combat vehicles, rotary wing aircraft, tactical/support vehicles, communications-electronics items and ammunition.¹⁵

A prime depot exists for every item requiring maintenance and each depot is an Army Center of Technical Excellence (CTX) for the commodities that it repairs. Other Services organize and operate their depots similar to the Army with variations to support unique missions.

DoD depots have tremendous capabilities and are an integral part of our defense industrial base. Such capability must be properly managed to sustain and support our warfighters.

Core Policy-Key to Achieving Proper Balance

Title 10, United States Code, requires the Secretary of Defense to maintain a logistics capability to ensure a ready and controlled source to technical competence and resources necessary

for effective and timely response to mobilization, national defense contingency situations and other emergency requirements.¹⁶ Title 10 also specifies that the Secretary shall identify those logistics activities that are necessary to achieve this capability.

Central to the entire issue of privatizing depot maintenance workload is the category of workload retained by DoD and offered to the private sector. Currently the Department of Defense has workload classified in two categories.

The first category is core workload. Core workload is the minimum depot maintenance organic depots and ship yards must perform to meet Title 10 requirements. A 15 November, 1993 memorandum entitled *Policy for Maintaining Core Depot Maintenance Capability* issued by the Deputy Under Secretary of Defense for Logistics describes core in these terms:¹⁷

Core workload is that "organic depot maintenance capability (including, personnel, equipment, and facilities) maintained by the Department of Defense as the ready and controlled source of technical competence and source necessary to ensure effective and timely response to a mobilization, national defense contingency situations, and other emergency requirements."

Non-core workload is workload not required to sustain DoD core depot maintenance capabilities or being accomplished as "last source of repair" or "best value" workload. To properly address what non-core workload is legitimately available for

privatization, it becomes important to first determine what core workload is absolutely essential to maintaining critical capabilities required in time of war. In order to quantify core, the Department of Defense has developed a workload sizing methodology that is largely contingency scenario driven as opposed to depot maintenance requirements driven. This relatively new approach to determining core workload is commonly called the core methodology and includes a series of conceptual steps which the Services use to size core workload.

Core methodology requires extensive cooperation from Congress, private industry, and the Services to achieve the proper workload balance between the public and private sectors. However, as the following review of the legislation governing management of depot maintenance will highlight, the level of cooperation is restricted by existing statutes.

Legal Impediments to Greater Privatization

There are currently several statutory and regulatory provisions that, in the opinion of both industry and the Department of the Defense, hinder DoD's ability to truly maximize significant savings from privatization and outsourcing. The Department of Defense has attempted on several occasions to convince Congress to either remove or ease some of the

restrictions curtailing greater privatization of depot workload. To date, this effort has been largely unsuccessful. Laws were passed by Congress to ensure that depot capabilities critical to supporting war fighting remained in depots. Legislation listed below currently restricts DoD's ability to increase its reliance on private sector support functions.¹⁸

Impediments: Statutory Restrictions -- Key Provisions

| <i>Citation</i> | <i>Summary</i> | <i>Citation</i> | <i>Summary</i> |
|-----------------|---|--------------------------|--|
| 10 USC 2461 | Mandates extensive reporting to Congress, including cost comparison study, prior to outsourcing | 10 USC 2469 | Depot maintenance work >\$3 M may not be outsourced without public/private cost comparison |
| 10 USC 2464 | Logistics requirements defined as "core" cannot be outsourced | Sec 8020, FY96 Appro Act | Requires MEO analysis of all functions of >10 DoD civilian employees before outsourcing |
| 10 USC 2465 | Prohibits outsourcing of civilian firefighting or security guard functions at military bases | Sec 8043, FY96 Appro Act | No funds for A-76 studies which exceed 24 months for 1 function or 48 months for >1 function |
| 10 USC 2466 | Limits outsourcing of depot maintenance to 40% of total | Sec 317, FY87 Auth Act | Prohibits contracting out of any function at McAlester or Crane Army Ammunition Plants |

DSB Task Force on Outsourcing & Privatization

Statutes outlined in the preceding chart display Congressional micro-management; levy extensive Congressional notifications and reporting requirements; and impose arbitrary laws such as the 60/40 rule that limit outsourcing to contractors.

Efforts to obtain relief from the current legal impediments have met tough resistance in Congress. The Deputy Secretary of

Defense and three of four military chiefs pushed extremely hard last year for more privatization. But despite their best efforts, House and Senate defense authorizers largely rejected their initiatives.¹⁹

The major reason for the rejection lies in the fact that DoD failed to provide analysis supporting many of its proposals. The Pentagon's "proposed depot policy was not well thought out, in general, and was not responsive to congressional guidance on several important issues," the Senate Armed Services Committee said in the report that accompanied its version of the FY '97 Defense Authorization Bill.²⁰ The committee further stated in its report that it was apparent that saving money was the main reason cited for greater outsourcing, but DoD provided no substantial analysis that increased outsourcing of depot workload would result in savings. The end result was that the Senate authorizers rejected a repeal of the 60/40 provision.

Equally disappointing was the fact that the Senate panel clearly rejected two of the key policy changes for which DoD and the aerospace industry have pushed: an end to competitions between public and private depots and the award to industry of maintenance contracts on new weapons systems. A review of various reports grading the testimony of the senior Pentagon

officials attempting to convince Congress to give the Pentagon more flexibility reveal, in part, why the proposal failed.

Deputy Defense Secretary John White and Air Force Materiel Command Chief, Gen. Henry Viccellio were unable to answer detailed questions about their proposal, and several times were chided by senators for giving answers that contradicted the policy DoD had outlined in a report to Congress.²¹ The House also rejected DoD's argument because of the administration's decision to "privatize in place" work at two closing depots in Texas and California.²² It is believed that this decision was inspired by politics. The Base Realignment and Closure Commission voted to close both depots citing excess capacity in the Air Force logistics system. However, President Clinton decreed that the work would be performed by private contractors in place, instead of shifting the workload to the three remaining Air Force depots in Georgia, Oklahoma and Utah.²³

Existing statutory requirements create a legal and regulatory environment that complicates, delays, and discourages greater outsourcing and privatization. A 1994 study conducted by the Defense Science Board concluded that relief from existing legislation is needed to provide the management flexibility

needed to maintain high readiness in the face of declining resources.²⁴

BRAC Impact on Depot Maintenance--Mixed Reviews

Although the impact of base closure decisions are less restrictive than the statutes cited above, the base closure commission recommendations sometimes restrict DoD's ability to take full advantage of privatization initiatives. A major part of the Department of Defense's plan to reduce excess infrastructure initially included the efforts of the Base Realignment and Closure Commission (BRAC). This was a bipartisan commission charged with the responsibility of determining and recommending to the President of the United States, installations and facilities, including depots, suitable for closure.

As one may suspect, the commission's work has not escaped criticism. For example, a recent Government Accounting Office report was critical of a BRAC's recommendation regarding the closure of the Red River Army Depot (RRAD). The Department of Defense forwarded to the BRAC Commission, the Army's recommendation that the depot be closed due to excess capacity. The recommendation was based on the fact that the depot's excess capacity was costly to taxpayers and violated prudent management.

The BRAC Commission countered and recommended that the depot

be downsized rather than closed. The BRAC Commission was concerned that a complete closure of the depot would adversely affect the ground combat vehicle readiness and sustainability and concluded that capability for the depot-level maintenance of ground combat vehicles should be maintained at more than one depot.²⁵ The commission recommended conducting musical chairs with the depot's workload by recommending all Bradley Fighting Vehicle workload be retained and other workload normally performed at RRAD be moved to other depots and to the private sector. The GAO report cited above stated that this BRAC decision left the Red River Army Depot with about 86 percent excess capacity which substantially increased operating costs. Based on an Army Materiel Command analysis, projected costs for residual Bradley-related workload will increase by \$15 per hour due to fixed overhead costs even with a much smaller workload base.

The GAO report supports its finding by using the following illustration: "the Red River depot currently is authorized 2,400 civilian employees to produce about 2 million direct labor hours of maintenance output. Of this number, overhead personnel account for about 21 percent of the depot work force.

After operations, the depot will produce 529,000 direct labor hours with an authorization of 1,476 civilians. The number of overhead personnel remains essentially unchanged under the downsized mode of operations, but the percentage of overhead personnel to total employees increases about 35 percent."²⁶

Although the BRAC Commission recommended that some workload go to the private sector, opportunities to maximize potential privatization of the Bradley workload was greatly reduced.

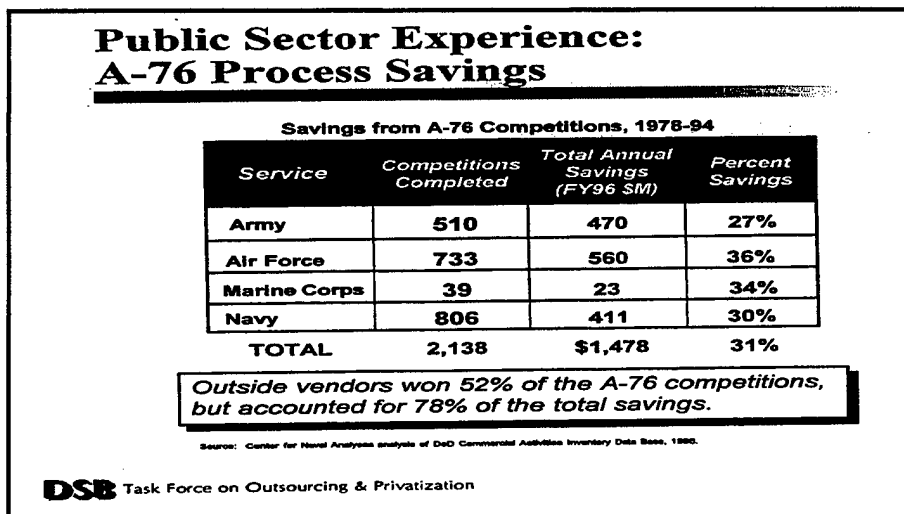
The Competition Policy

Last years' DoD depot maintenance report to Congress indicated a desire to shift a greater share of depot maintenance to the private sector. Specifically, the report cited DoD's commitment to move more work to the private sector.

Relying more on the private sector will allow greater flexibility in reducing overcapacity.²⁷

Competition is the traditional process that thrives on the free market system to determine the allocation of goods and services. In theory, promoting competition brings about the best price, quality, and timely delivery of the product. Whether or not a competition is meaningful in the true economic sense when public depots compete against private depots is questionable. However, as the chart below illustrates, documented savings from

competition total about \$1.5 billion annually. Outside vendors won more than half of the competitions and accounted for 78% of the total savings between 1978 and 1994. The bottomline is that increased outsourcing would improve savings within DoD.



Industry's Perspective on the DoD Competition Policy

The free market concept of competition is fully supported by industry. Industry, however, does not support the concept of public/private depot competition as currently designed.

Industry believes that it is inappropriate for the government to compete with its citizens.²⁸

Private industry is also concerned about the fact that public depots are aggressively bidding and winning depot work that used to be done by contractors. For example, in 1992, the Air Force competed against private contractors for repair work on the C-141 built by Lockheed, and won.²⁹ Although the objective

of competitions between public depots and private industry is to promote maximum efficiency at the best possible price, industry officials believe that the government has an unfair advantage.

As part of a long-term industry effort, the Aerospace Industries Association, the National Security Industrial Association, and the American Defense Preparedness Association, recently formed an industry working group to specifically address Public-Private Depot Competition (PPDC). This industry working group will develop industry recommendations for fair and equitable competitions for depot maintenance workloads, and attempt to build support necessary to implement those recommendations in government policies and practices. This is the first time in the depot arena that industry has joined forces in a collaborative effort to address what it perceives to be an unlevelled playing field in the public-private competition program.

The major complaint from industry centers around two issues, the methodology used to award the bid and DoD's cost accounting system used to determine what costs comprise the bid requirements.

Regarding the first issue, bid methodology, private industry points out that the competition's source selection authority is

generally affiliated with the depot organization making the government's offer. Although regulations and policies are in place to prevent a conflict of interest, industry clearly believes the potential exists. Additionally, when a private firm bids firm-fixed price, that fixed price is the only source of revenue that the firm can use to cover costs. However, when public depots bid firm-fixed price, the offered price is not the only source of revenue and may be offset by price adjustments elsewhere, additional funding, or simply moved forward as incomplete work into a future budget cycle.

The second concern voiced by industry, is that the cost accounting system fails to employ the same contract cost accounting and performance measurements as the private sector. For example, government costs generally exclude the expense of operating a headquarters, while industry costs includes such expense. Still another example frequently cited by private contractors is that service bids include benefit costs for all civilians, but not for uniformed personnel.³⁰ Industry must include benefit costs for personnel required to complete the workload.

There is some legitimacy to industry's concerns. Cooper and Lybrand, a prominent accounting firm, while reviewing public-

private competitions to date found that "internal controls relative to contract performance at the contract and project level at the depots were found to be non-existent or very weak."³¹

It also appears that this very issue contributed to the Deputy Secretary of Defense's 1994 decision to stop public-private depot competition. His May 4, 1994 memorandum, "Depot Maintenance Operations Policy" states:

"With regards to competition between the public depots and the private sector...Data bases and financial management systems in the Departments of the Military Services are not capable of supporting the determination of actual cost of specific workloads. Although a vigorous attempt has been made to execute fair public-private competitions through the media of the Cost Comparability Handbook, a level playing field is not achievable in the near-term. Based on these findings, public-private competition will be discontinued at present."³²

Suspension of the competition program demonstrated a bold step on the part of DoD, and clearly illustrates its commitment to insuring a level playing field for public-private competition exist. The DoD memorandum also adds validity to industry's complaints.

Competition Policy: Bridging the Gap

In response to industry's concerns, DoD formed an Integrated Process Team, which included representation from industry to study the issues associated with price disparities. Although the results of the group's effort are not yet available, informal

reports indicate that several of industry's concerns were adequately addressed. This is further supported by the fact that DoD recently staffed for comments among the Services, a memorandum that reverses the 1994 suspension of public-private competition.

Clearly this collaborative approach to mitigating the differences cited above lays the foundation for a more efficient and effective public-private competition program. Unfortunately, current legal impediments like the aforementioned "60/40" rule, hinders the competition by causing the retention of depot workload even when private industry can perform the task more efficiently and at greater savings.

Government Employee Reaction to Competition

As previously discussed, there are many interested parties focusing their efforts on retaining as much depot maintenance workload as possible within the public sector. One group is the depot government workers who have formed a strong grass roots effort that aggressively works to safeguard their livelihoods. These workers consider themselves highly talented and clearly focused on safeguarding our national security requirements. They are well aware of industry's efforts to capture a much greater share of our nation's shrinking defense dollars.

These employees have successfully focused the attention of their unions, as well as that of their regional and national politicians, on safeguarding depot workload.

For example, in March, 1996, the American Federation of Government Employees (AFGE), AFL-CIO, filed a lawsuit in the federal court in Columbus, Ohio. The suit alleges that CORE work at the Newark, Kelly, and McCellan Air Force Bases is being illegally privatized at great risk to our national security. Note the terminology used to highlight the deep concern expressed by the union. The union chose to align privatization with risk to our national security.

Mr. John N. Sturdivant, AFGE National President, stated the following: "Our nation will not stand idly by while critical defense measures are ignored."³³ Furthermore, "AFGE defense workers know more than anyone else on how to keep this nation ready for any military emergency."³⁴

The March 96 suit also challenges the legitimacy of the Base Realignment and Closure Commission (BRAC) procedure. AFGE has named President Clinton as the defendant based on his personal involvement in directing the Department of Defense to disregard the BRAC process and prevailing laws. It is AFGE's position that according to 10 U.S.C. 2464 and 2469, the Clinton administration

has violated provisions which require the bidding for the work to include other depots and DoD facilities, not just the private contractors.

It is AFGE's belief that short-term profit interest is prevalent throughout the aerospace industry even at the expense of our national security requirements.³⁵ A major key to insuring our industrial base remains solvent while simultaneously achieving efficiency is convincing our government workers that there is a valid requirement in both the private sector as well as the public sector.

Conclusion

Greater outsourcing and privatization of DoD's depot maintenance can significantly increase savings, which DoD can then use to improve and sustain the force. Based on DoD's most recent revision of how it defines core workload and plans for increased privatization initiatives, it is clear that DoD is fully committed to shifting more workload to the private sector.

However, the Department of Defense's efforts to increase savings through depot maintenance privatization, can only be optimized if Congress eases or removes many of the legal restrictions. The politicization of the process simply undermines any aggressive outsourcing and/or privatization

opportunities DoD may pursue. Unless the Pentagon and Congress are able to come to grips with these crucial decisions soon to ensure the Defense Department has the flexibility to buy the most cost-effective goods and services available in the marketplace, the nation will be jeopardizing its long-term military readiness.

Once Congress allows greater flexibility, DoD and private industry must decide on the appropriate balance for each institution in light of associated risks DoD is willing to accept. At this stage, the use of sound, professional analysis and judgment becomes absolutely essential in determining the proper workload distribution between government and industry. Although, not necessarily viewed by industry as the best alternative, partnerships between government and the private sector should continue to evolve. When performed in optimum fashion, these partnerships build trust between the public and private sectors, allows both sectors to contribute their best assets, as well as save scarce resources.

Equally important is DoD's commitment to continually address industry's concerns regarding the application of competitive bidding procedures. Proper resolution of bidding issues is a critical step if DoD plans to achieve greater savings by moving more depot maintenance workload to private industry. Only then

will a public-private competition system exist that is efficient, yet flexible enough to support future contingencies.

Another key issue to striking the proper depot maintenance balance is industry's ability to assure DoD it will provide uninterrupted support during national emergencies. This includes retaining the capabilities, such as core workload, to meet essential wartime surge demands. Finally, with government and industry working together, given the flexibility from Congress, our nation will maintain a ready military force. The additional savings achieved from purchasing the most cost-effective goods and savings available can then be used towards modernization of our forces.

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²⁷ibid.

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²⁹Joel W. Marsh "Food For Thought on Public/Private Depot Maintenance Competition", Briefing for the National Security Industrial Association's Outsourcing and Privatization Workshop, 2 October 1996.

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³⁵ibid.

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