NAVSEA NAVAL SEA SYSTEMS COMMAND

NAVAL SEA SYSTEMS COMMAND SEA 05C COST ENGINEERING & INDUSTRIAL ANALYSIS DIVISION

Accurate
Credible
Defensible

Should Cost Management

February 2012

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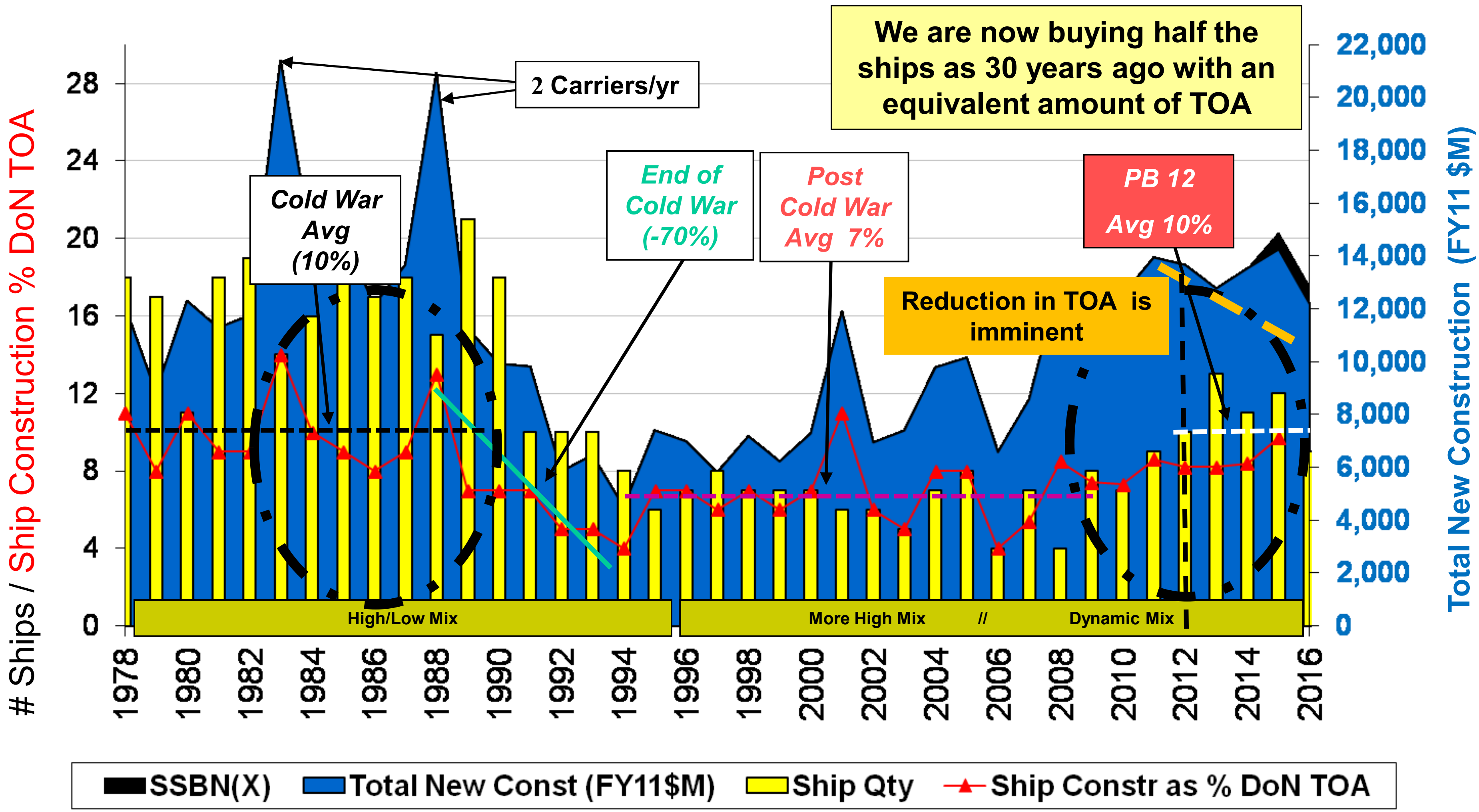
Driving Change in Navy Acquisition

*"…In this fiscal environment, **every program**, **every contract**, **every facility** will be scrutinized for savings - savings that won't reduce readiness or our ability to perform essential missions..."*

- Defense Secretary Leon Panetta
Remarks made to Congress-
October 11, 2011

Shipbuilding Procurement History



Better Buying Strategies are key to addressing the issues of affordability

2011 NDAA Language

(H.R. 6523, Subtitle B, Sec. 811)

- Recognizes the difference between “estimates for program baselines and analysis” and “targets for contract negotiation purposes” and amends *Section 2334 of Title 10, United States Code* as follows:
  - “(A) cost estimates developed for baseline descriptions and other program purposes conducted pursuant to the subsections (a)(6) (i.e., independent cost estimates and cost analyses) **are not to be used for the purpose of contract negotiations or the obligation of funds**; and
  - (B) cost analyses and targets developed for the purpose of contract negotiations and the obligation of funds are **based on the Government’s reasonable expectation of successful contract performance…”**

WILL COST / SHOULD COST

ASHTON B. CARTER, SECDEF, MEMO (14 SEP 2010)

MEMORANDOM FOR ACQUISITION PROFESSIONALS

SUBJECT: Better Buying Power; Guidance for Obtaining Greater Efficiency and Productivity in Defense Spending

"TARGET AFFORDABILITY AND CONTROL COST GROWTH"

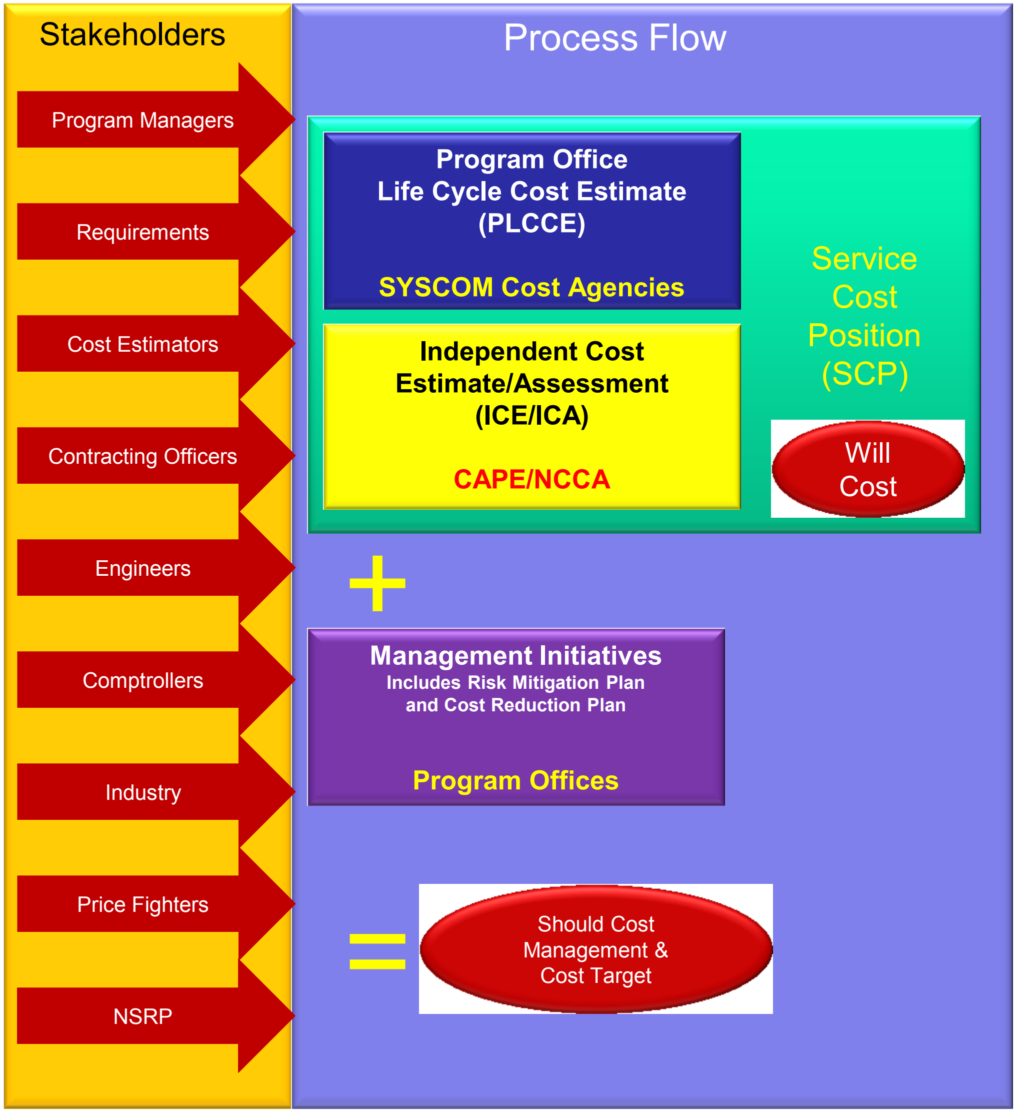
Drive productivity growth through Will Cost/Should Cost Management. During contract negotiations and program execution, our managers should be driving productivity improvement in their programs. "They should be scrutinizing every element of program cost, assessing whether each element can be reduced relative to the year before, challenging learning curves, dissecting overheads and indirect costs, and targeting cost reduction with profit incentive – in short, executing to what the program *should cost*."

"… I will require the manager of each major program to conduct a Should Cost analysis justifying each element of program cost and showing how it is improving year by year or meeting other relevant benchmarks for value."

DoN Guidance

- *"Program managers, through continuous Should-Cost Management, will identify discrete, and measurable actions or initiatives that achieve savings against the Will-Cost estimate."*
- *"The program office is responsible for developing Should-Cost management targets and initiatives along with all tracking and reporting requirements."*
- *"For ACAT I programs, the Will-Cost estimate is the CAPE Independent Cost Estimate or the Service Cost Position."*
- *"Will-Cost estimates for ACAT II and III programs will be presented at milestone decisions and approved by SYSCOM cost estimating organizations…"*
- *"USD (AT&L) and ASN (RD&A) will approve Should Cost Management targets at milestones and at annual Gate reviews/ Configuration Steering Boards."*
- *"Program offices, SYSCOM cost staffs, and NCCA will ensure full incorporation of the achieved savings into updated Will-Cost Estimates."*

Should Cost Management (program execution targets) Development



- Service Cost Position
  - A reconciliation of the PLCCE and the ICE or ICA
  - Represents the "Will" cost position for the program
  - Identifies key cost drivers and areas of risk
- Management Initiatives
  - Leverages information from the PLCCE or SCP on key cost drivers and risk
  - Relies on cross-functional collaboration
    - Program Managers
    - Cost Estimators
    - Comptrollers
    - Engineers
    - Contracting Officers
  - Includes a detailed Risk Mitigation Plan and a Cost Reduction Plan
  - Identifies savings that can be reasonably achieved by changes in processes, materials, or investment in new technology
- Program "Should" Cost Management
  - Determined by decreasing the SCP by the value of savings identified through management initiatives
  - Tracked by PEOs as programs progress over time

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Should Cost Management in a Nutshell

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Critical Elements

- Requirements Management
- Acquisition Strategy that Maximizes Competition and Shares Risk
- Aggressive Schedule Management
- Detailed Understanding and Management of All Costs
- Active Risk and Opportunity Management Approach

- Should cost management requires us to work as a team, not just in our functional "swim lanes"
- Identifying opportunities
  - Major cost drivers from "will-cost" estimate
  - Major areas of risk from "will cost" estimate
  - Industry benchmarks and best practices
- Meeting challenges
  - Scrutinizing every element of cost
  - Providing proper incentives
  - Financial/contractual challenges
- Measure progress
- Industry can succeed in this environment

IF WE DON'T CONTROL OUR COSTS, SOMEONE ELSE WILL

Diving Deep Enables Better Insight and Understanding

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CORPORATE ANALYSIS
PUBLICLY AVAILABLE

CORPORATE OVERVIEW
- ORGANIZATION
  - SECTORS
- EXECUTIVES
- BOARD OF DIRECTORS
  - HIGHLIGHT RETIRED MILITARY/ DoD
- NAVY PORTFOLIO

EXECUTIVE COMPENSATION
- PERFORMANCE PAY vs. SALARY
  - TOP 5
- CRITERIA

CORP/SECTOR FINANCIAL ANALYSIS
- REVENUE GROWTH
- OPERATING MARGINS
- CAPITAL INVESTMENT
- CASH FLOW
- RATIO ANALYSIS
- DEFENSE AVERAGE COMPARABLE

BIG PICTURE
- EDUCATED BUYER
- INDUSTRY MOTIVATION AND INSIGHT
- IDENTIFICATION OF RISKS AND OPPORTUNITES

"DEEP DIVE"
COMPETITION SENSITIVE

ECONOMICS
- INFLATION
- LOCAL UNEMPLOYMENT
- LOCAL MARKET LABOR RATES
- UNION REPRESENTATION
- LOCAL INCENTIVES
- INDUSTRY PRODUCTIVITY

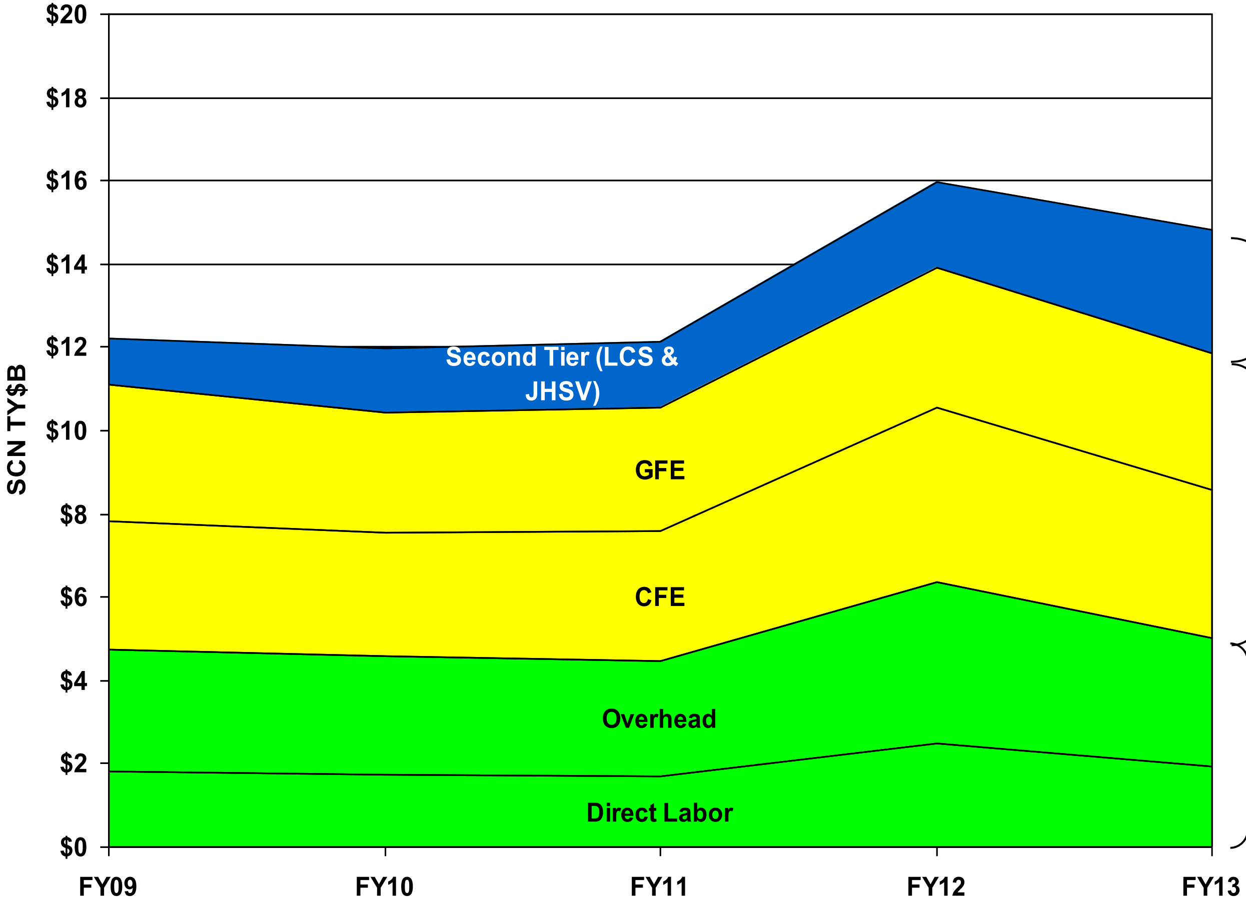
SUPPLIER BASE
- MAKE vs. BUY
- SUPPLIER NETWORK
- WORKLOAD
- CAPACITY
- TECH LEADER or FOLLOWER
- WHO HAS THE INTELLECTUAL PROPERTY – PRIME OR SUPPLIER

PAST PERFORMANCE C/S
- EARNED VALUE
- CPARs
- RECORD OF PAST EFFORTS AT DESIGN AND PROCESS COST REDUCTION INITIATIVES

COST STRUCTURE
- ELEMENTS
  - MAT'.L, LABOR, O/H
  - SOURCING STRATEGIES
  - RAW MAT'L & COMPONENTS
  - LABOR SKILLS AND UNIONS
  - FIXED V. VARIABLE O/H AND DRIVERS
- COST TRENDS & COMPARISONS
  - DIRECT
  - INDIRECT

TACTICAL
- ACQUISITION STRATEGY DEVELOPMENT
- PREPARATION FOR CONTRACT NEGOTIATION
- ENABLER FOR "WILL/ SHOULD" COST

Where are the Opportunities?

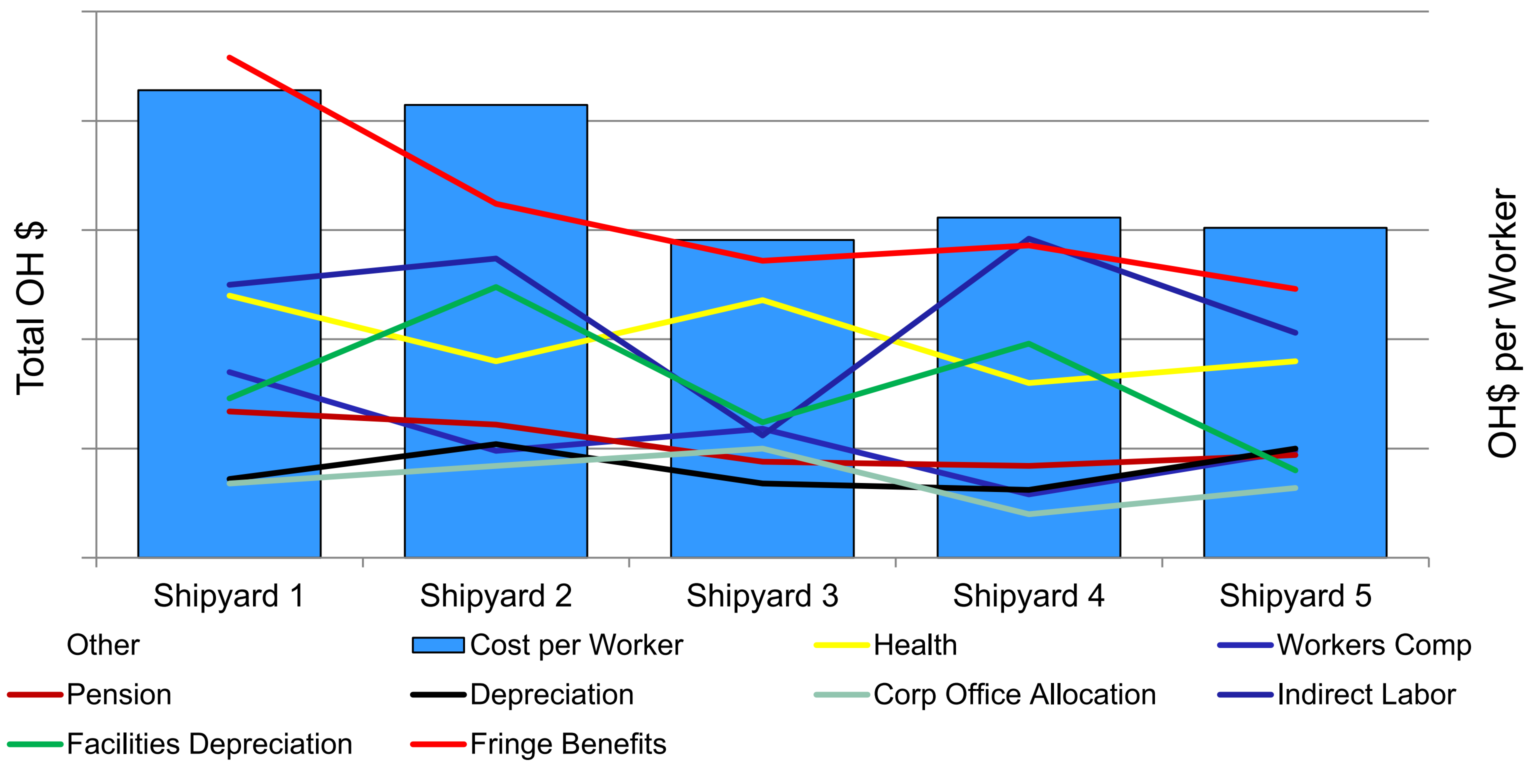


Second Tier = 14% ($9B)
Already competitive.

Material = 49% ($33B)
Opportunities exist to reduce cost.

Labor = 37% ($25B)
Opportunities exist to reduce cost, but Congressional desire to maintain our shipyards constrains opportunities.

Benchmarking Provides Should-Cost Opportunities



Benchmarking and finding best practices in shipyards and in supplier facilities helps identify opportunities for improved efficiency.

Should Cost Management Summary

- Should Cost Management Opportunities
  - Commonality program savings
  - Learning curve improvements
  - Process Improvements
  - Changes in Contracting
  - Gov’t Furnished Equipment

- What Not to Include in a Should Cost Target
  - Straight percentage reductions
  - Large investments with no near-term cost recovery