# EMPOWERING GOVERNMENTS TO BUY SMARTER IN DEFENSE

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In responding to pandemic-related pressure on defense budgets, the challenge for governments is not simply to spend less but to spend smarter on defense—and to do so in a way that allows them to generate the maximum military readiness for every dollar spent.

The industrial base is at the center of the financial imbalance, and defense contractors have several advantages in how they negotiate with government acquisition teams. For example, governments often lack transparency in terms of contractors' true costs and business objectives, an information asymmetry that advantages suppliers. Government buyers also face tight deadlines to commit funds with a "fair and reasonable" determination—in some jurisdictions—and limited incentive to drive greater affordability beyond their budget.

Resetting the relationships with contractors has always been an opportunity for governments, but the increased fiscal pressure due to the pandemic is making it an imperative. The key to unlocking this opportunity may be to partner with contractors in order to reframe the way governments think about negotiating costs so that they focus on total cost rather than simply profit lines. From our experience, we believe that four measures will give governments a systematic means to improve their negotiations with defense contractors—and ultimately improve military readiness.

## Declining Budgets and Growing Needs

Projections call for worldwide GDP to contract by about 5% in 2020, with significant uncertainty in subsequent years as well. Policymakers—who already face stagnant economies, decreased tax revenues, and steep pandemic-related expenditures—will also be forced to cut spending in many areas, putting pressure on defense budgets.

Those reductions will compound challenges in defense readiness around the globe. Among NATO countries in 2019, for example, governments spent nearly $87 billion less than their target commitment of 2% of GDP—an aggregate amount that is larger than the entire annual defense budget of any country besides the US or China. Since the 1980s, NATO defense spending as a share of GDP has declined by 48%, and it has not kept pace with inflation since 2009, leading to material gaps. (See the exhibit.)

Given this challenge—the need to spend less while still maintaining, or even increasing, military readiness—governments must ensure that they get the maximum possible impact for their allocated defense budget.

## Five Challenges for Governments

Most governments struggle to negotiate effectively with defense suppliers. From our extensive work in supporting governments, we believe that many of those challenges can be grouped into five main categories.

### Information Asymmetry

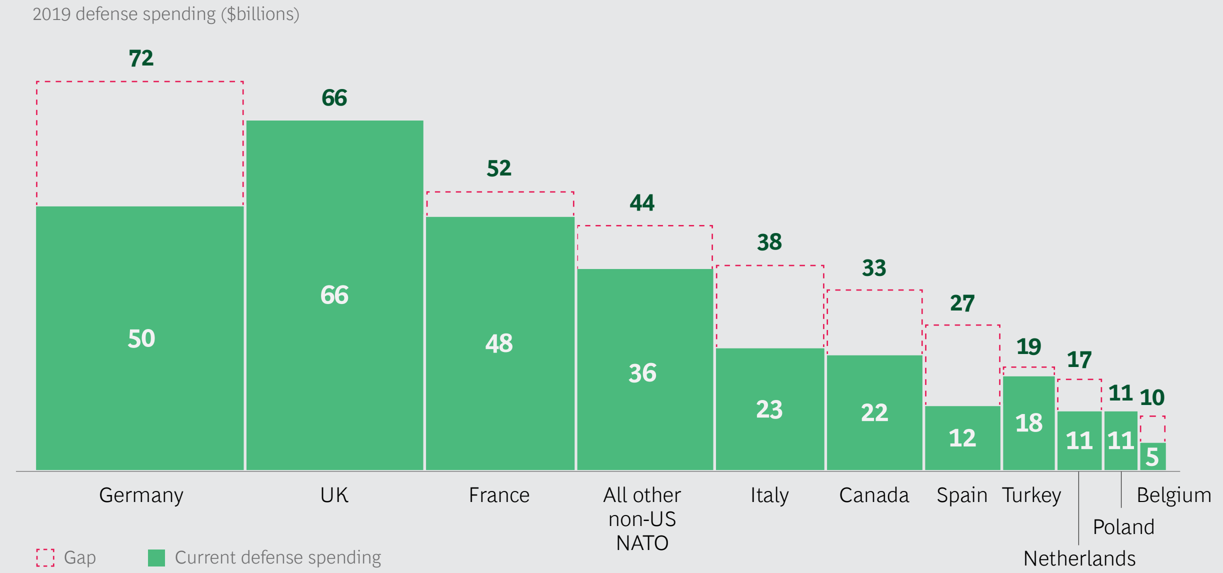
Governments typically do not have insight into a supplier's true financial situation and cost drivers in a given proposal. These include factors such as supplier production volumes, learning rates (in which labor costs for a particular product decline over time), and commercial synergies (in which a defense component may be largely similar to a component the supplier makes for nondefense customers, sometimes even products on the same manufacturing line).

The current understanding of supplier operations and costs is especially problematic owing to the volume of sole source negotiations, in which a supplier faces limited competition. In the US in 2018, for example, 67% of contracts went to a single bidder, limiting the use of competition to drive transparency and achieve market pricing.

### A Lack of Coordination Among Government Buyers

Governments also struggle to capture synergies and leverage their scale with suppliers, primarily because of siloed funding and decision making across programs and life cycles. And even when governments can build up insights on particular suppliers over time, they are inhibited from sharing that information with other programs because of regulations, cultural barriers, and data capture inconsistencies across programs and services.

Defense Spending for Most NATO Countries (ex-US) Falls Short of the Target of 2% of GDP




**Sources:** NATO; BCG analysis.
**Note:** The "gap" refers to the amount in current (2019) defense spending that would be required to reach the 2% of GDP threshold for each NATO country. The width of the country's bar corresponds to 2019 GDP, in billions. Defense spending uses constant 2015 prices and exchange rates. All other non-US NATO countries are below top ten GDP members, including Norway, Denmark, Portugal, Romania, Czech Republic, Greece, Hungary, Slovak Republic, Luxembourg, Bulgaria, Croatia, Slovenia, Lithuania, Estonia, Latvia, Albania, and Montenegro.

Suppliers also frequently sidestep formal negotiation communication channels, electing to use informal "backdoor selling" channels across government stakeholders, creating challenges for government negotiators to maintain consistent messaging. If a supplier faces pressure to reduce costs on a bid, the leadership team of that company can reach out to other points of contact in a defense ministry and plead its case. Consider that all five of the largest US defense contractors have previous members of the Joint Chiefs of Staff or major buying organizations on their boards of directors, giving them direct access to key government decision makers.

Politics can also drive decision making, with elected officials lobbying for procurement decisions that benefit their constituents, rather than striving to save money for the government overall.

### Misaligned Incentives

Acquisition executives are typically evaluated according to their ability to spend allocated funds on schedule (also known as their obligation rates) and comply with regulations. Those objectives are frequently at cross-purposes with the bigger goal of maximizing capabilities. Obligation rates are a critical metric that is tracked at the senior-leadership level. Contracting officers have limited timelines and must make fair and reasonable determinations that are based on complete contract reviews of pricing proposals. And these proposals can run 500 pages or more and don't always allow for machine searching of key terms and pricing.

In addition, the fair and reasonable standard is often relatively easy to meet—for example, any price that a government paid in the past is deemed fair and reasonable in the future. The goal for governments should be to exceed that standard and negotiate a good price for a given acquisition.

### Mission Realities

Defense acquisitions frequently involve unique products that have limited commercial analogs and are sourced from an extremely limited set of suppliers. In the US, five contractors accounted for 44% of spending on major programs in 2018. Above all, the program offices and the government-contracting officials must meet the military's operational needs, which outweigh all other considerations.

### Calendar Constraints

Finally, governments typically appropriate money for a given fiscal year, and buyers have limited discretion to carry money over to subsequent years. As a result, the calendar works against government in three ways. First, purchasers have an incentive to spend money, regardless of need or price, to ensure that funds get spent. Second, buying under arbitrary deadlines may prevent governments from consolidating spending to secure volume discounts. Third, contractors recognize that the calendar works against government buyers and often run out the clock on the government during negotiations in order to force a hasty decision on suboptimal terms.

## How Suppliers Protect Profit Margins

To simplify the complexity of defense procurement, governments frequently focus their negotiation strategy on profit margins, zeroing in on efforts to minimize the percentage profit that a supplier secures. But this approach leads some governments to ignore the biggest drivers of cost.

Suppliers, in contrast, take a more holistic approach to value, considering not only their operational costs but the overall profit and value of a program over a life cycle, including both the acquisition component and the required sustainment support for a platform once it is operational (for example, in areas such as maintenance and spare parts).

Given that disparity, governments can strengthen their negotiations by considering an acquisition negotiation from the perspective of the supplier. In our experience, there are several ways that suppliers can increase their proposed costs on a given contract—and thus generate higher fees, which are based on costs, and greater value in every other dimension of their operations—regardless of the final profit percentage they agree to during the negotiations.

### Excess Labor Volumes

Although suppliers are required to disclose actual cost data to the government, they have significant flexibility in which data they share. Selectively choosing data can allow suppliers to claim that they will see only minimal—or no—benefit from labor learning curves. Then, as they become more efficient at producing a given component over time, they can capture more of that value for themselves. Even when contractors show some performance improvement over time, government buyers often don't have the insights or ability to push for even greater gains.

For example, a prime contractor recently estimated future labor hours for more than 100 line items and assumed no labor efficiencies for the duration of the contract. Yet it had historical data showing significant gains in efficiency as the result of learning curves (up to 70% in some cases). This not only increased the cost of the contract but had a second-order effect of raising program management costs as well once the asset went into operation, since those were based on contracted labor hours.

### Ever-Increasing Prices

Suppliers have built an expectation of cost increases into many government procurement organizations and price their proposals accordingly. Yet the cost of manufactured products often declines over time (Moore's law is a famous example). For instance, a major acquisition program received a proposal that assumed annual material price escalations of 5%. That rate of growth was more than double the historical increases. And external benchmarks for similar products showed annual price declines. Building in a cushion for price increases creates value if suppliers can maintain cost controls within their own operations—in essence, they can, in many contract types, keep whatever savings they generate. In some cases, we have seen suppliers win a contract based on a proposal to lower costs and later renegotiate for a higher price.

### Noncompetitive Sub-Supplier Costs

Governments typically do not motivate contractors to aggressively negotiate down costs for their own network of suppliers. Accepting sub-supplier quotes at face value and building those into acquisition bids benefits suppliers by allowing them to defer savings until they can capture more value (for example, on fixed-price contracts) or focus their negotiations with sub-suppliers on areas that benefit the contractor—such as reducing supply risk. As with labor costs, even when suppliers show some gains in terms of securing lower material costs, government buyers should be able to push them for further improvements.

For example, an aerospace prime contractor with significant commercial and defense business units negotiated aggressively for cost savings for its commercial business while accepting above-market prices on similar products for defense customers. Working with the government, we identified a way to reduce costs by more than 60%.

In many cases, we have seen cost data provided to the government that shows sub-suppliers earning unexpectedly high fees, with actual profit margins exceeding 100% in some cases. But the government was unable to use this information in follow-on negotiations with the incumbent prime contractor because of confidentiality requirements.

### Inflated Indirect Rates

Indirect rates are allocated to programs out of larger cost pools at the site, business unit, or corporate level, obscuring government cost analysts' ability to look through the data and holistically assess costs. As a result, suppliers can set indirect rates according to conservative assumptions, with a reasonable expectation that they can outperform and keep the savings.

For example, we observed a supplier setting overhead assumptions for production of a high-profile acquisition and modeling costs on the basis only of the projected growth of the single program being proposed. That determination didn't account for likely foreign sales of products built at the site or growth in other parts of the business. This amounts to a risk transfer, in which the government bears the risk of the supplier's business underperforming.

## Four Measures for Governments to Improve Their Negotiations with Contractors

Given the increased fiscal pressures that governments face, they need to reorient their acquisition strategies in order to maximize the potential value from defense budgets. We have identified four very actionable, high-impact steps governments can take.

### Develop Insights into Supplier Operations

Understanding the operations of suppliers is essential to revealing the true economics of production. For example, suppliers often claim that a product is unique, even though they produce it in manufacturing facilities used for other components and benefit from material-sourcing economies of scale and labor learning curves, all of which can lower costs. By understanding these factors and supplementing supplier-provided data with information from market data sources, acquisition officials can generate a more accurate data-based sense of what a product should cost to manufacture, rather than relying on general decrements or independent cost estimates based on supplier-provided data.

### Standardize Proposals to Provide Cost Transparency

Acquisition teams, particularly those on complex technical products, often contend with nonstandardized proposals that have dense supporting documentation. Merely making sense of this information consumes significant time, which—given obligation schedules—means teams may not have time to review the material in sufficient depth. Instead, governments should redesign proposal submissions from the bottom up, creating a standardized format that makes critical data more accessible and transparent. Standardized formats also enable governments to use analytics in order to accelerate reviews.

### Align Internal Stakeholders on the Objectives, Approach, and Messaging

Ensuring internal alignment across levels and functions is essential to negotiation success. Backdoor selling is a commonly deployed negotiation tactic by suppliers looking to exploit the natural government divisions across contracting officers, program, engineering, and senior leadership. By aligning all stakeholders on the government side before negotiations begin, governments can mitigate this kind of backchannel sales effort.

### Reorient the Focus Away from Profit Margins to Total Cost Reduction

Improving readiness requires a decrease in total system costs, regardless of the stated supplier profit margin. Instead of focusing on the profit line, governments should look to reduce total costs. In some cases, that may mean giving suppliers an incentive to generate efficiencies on their side. For example, a government could propose a share-in-savings deal where ultimately the government benefits from a lower total cost, even when suppliers realize a higher profit.

If given the proper incentives, defense suppliers can help governments improve military readiness through constant innovation and a joint commitment to improving national defense. As the current crisis shows, these suppliers are essential to the commercial sector and contribute to jobs and economic growth.

But governments should also be able to generate fair value for their defense spending, especially given the need to increase readiness while potentially reducing budgets. Government teams in many instances are highly capable but face organizational challenges and timeline realities that make it difficult to generate greater value with existing approaches and tools.

Governments will have to adopt a variety of new strategies in order to meet the readiness needs of the future. Success requires resetting relationships with suppliers by focusing on the biggest cost drivers, informed by a deep understanding of supplier operations and finances. Doing so can help to mitigate the impending defense budget pressures and ensure that governments can meet their readiness goals in the years ahead.

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