

Workforce Cost Comparison: An Alternative Approach

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Over the past decade, federal spending on professional services nearly doubled (in constant terms) from \$150 billion in 2000 to \$290 billion in 2010. Spending on all service contracts more than doubled during this period, from \$164 billion in 2000 to \$343 billion in 2010.¹ Recent policies have attempted to reverse this outsourcing trend, touting insourcing of services as a means to generate cost savings, yet providing little data or guidance on how this will be achieved. The Defense Department (DoD) has been particularly active in this field. In April 2009, Defense Secretary Robert Gates announced a plan to replace some 30,000 contractors with DoD civilian employees between 2010 and 2015.² Assuming that federal employees would be significantly less costly than contractors, DoD expected budgetary savings equal to 40 percent of the cost of the contractors being replaced. More recent DoD statements claimed savings of 25 percent, yet neither figure appears justifiable. Rather, research has shown that the majority of savings from public-private competitions—around 65 percent—derive from the competition itself, not from any intrinsic advantage on either the public or private side.³ Yet despite dissatisfaction of DoD leadership with the initiative's results, the FY 2010 DoD budget reflected those savings, as have subsequent DoD budget proposals to Congress.

This article summarizes a study the Center for Strategic and International Studies completed in April that identified the shortfalls in current and past cost

estimation mechanisms DoD used for conducting sourcing decisions between private- and public-sector providers. This study also developed an alternative cost comparison methodology.

The Current Cost Comparison Methodology: The Directive Type Memo

In Jan. 2010, DoD's Director for Cost Analysis and Program Evaluation (CAPE) signed Directive Type Memorandum (DTM) 09-007 "Estimating and Comparing the Full Costs of Civilian and Military Manpower and Contract Support." This DTM constitutes current DoD guidance for insourcing decisions and the National Defense Authorization Act for FY 2011 mandates DoD use the DTM's costing methodology "or any successor guidance for the determination of costs when costs are the sole basis for the decision."

However, there are key shortcomings in the procedures laid out in the DTM for calculating the government's costs for performing a service. Specifically, the DTM:

- Lacks ability to calculate fully burdened government wide costs;
- Fails to account for the full cost of DoD-owned capital but includes those costs for contractors;
- Fails to account for taxes forgone by the federal treasury or state or local governments;
- Fails to account for the inherent risk of cost growth among public producers;
- Overlooks the imputed costs of insuring and indemnifying in-house producers;

- Fails to use a detailed scope of work as a basis for cost estimation; and
- Lacks specificity on how to calculate cost components.

Of these shortcomings, the first is critical. If the true cost of public performance of commercial services cannot be determined, any budget-driven insourcing decision becomes immediately suspect. Even for insourcing decisions conducted on the basis of inherently governmental considerations, DoD should still understand the full budgetary implications of the decision so that it can properly weigh the benefit gained from boosting in-house capabilities against the budgetary impact.

Previous Cost Comparison Methodology: OMB's Circular A-76

OMB Circular A-76 (first issued in 1966 and most recently revised in 2003) was the previous cost comparison methodology used by DoD. It is a more useful tool than the DTM for cost comparisons between the public and the private sector in several respects. Most notably, the A-76 methodology provides greater specificity on major cost components, enabling cost estimators to compute a greater range of fully burdened costs. In contrast to the DTM, which provides only general explanations (aside from direct labor costs), A-76 provides line-item specificity for many cost elements. Key advantages of A-76 over the DTM are that it:

- Includes the cost of in-house production at a private-sector rate of

¹ Center for Strategic and International Studies (2010) Structure and Dynamics of the U.S. Federal Professional Services Industrial Base, CSIS, Washington, DC.

² Gates, Robert M., Defense Budget Recommendation Statement, as prepared for delivery, Arlington VA, April 06, 2009.

³ Snyder, Christopher, Robert Trost, and Derek Trunkey (1998) Bidding Behavior in DoD's Commercial Activities Competitions, Center for Naval Analyses, Alexandria, VA; Trunkey, Derek, Robert Trost, and Christopher Snyder (1996) Analysis of DoD's Commercial Activities Program, Center for Naval Analyses, Alexandria VA.

- return on new investments;
- Includes forgone federal taxes as a cost element for in-house producers;
- Requires that in-house producers take into account the imputed cost of insurance; and
- Requires a performance work statement.

At the same time, A-76 has flaws which must be recognized. The two major points of contention are the use of a blanket 12 percent overhead rate for all government functions and a failure to account for the true cost of capital on the public side.

The CSIS Cost Estimation Methodology

Given the inadequacies of current and previous cost comparison methodologies for DoD, CSIS developed an alternative taxonomy and methodology intended to provide the basis for uniform and analytically sound procedures to determine accurate cost estimates of private and public sector performance. Determining these costs will enable a more transparent and fair conduct of public-private competitions for potential insourcing and outsourcing of commercial activities. The CSIS methodology draws on the cost comparison guidelines developed in the most updated version of A-76 and the DTM, while addressing the key shortcomings of both.

The foundation of the CSIS cost estimation methodology is a clear, detailed statement of work (SOW). Conducting meaningful public-private cost comparisons or public-sector cost estimates requires a common starting ground with uniform, clearly defined performance parameters. Issuing a binding SOW at the beginning of each competition would create a level playing field for both sides and ensure that private and public bids would be evaluated based on identical criteria, pre- and post-contract award. Such a SOW should, at a minimum, include the following components:

Personnel	Overhead	Facilities	Additional Costs
Direct Labor (Military & Civilian)	Operational Overhead - Management & Oversight	Cost of Facility	Liability Insurance
Fringe (Including Health Insurance & Retirement)	Information Technology	Rent	Travel
	HR/Personnel	Insurance	Subcontracts
	Legal Support	Maintenance & Repair	Nonrecurring Workloads
	Accounting	Utilities	Minor Items
	Payroll	Capital Improvements	Medical Exams
	Headquarters Management	Capital	Training
	Miscellaneous	Cost of Capital	Cost Growth
		Depreciation	Conversion Costs
			Administration & Oversight Costs

- A clear description of the scope of work associated with the activity;
- Historic workload data, including workload stability from which quantitative and qualitative staffing requirements can be deduced;
- Clearly defined performance parameters with minimum requirements and, if applicable, evaluation criteria for performance in excess of these requirements;
- A stated period of performance;
- Availability of government furnished equipment, materials and services; and
- Quality and oversight requirements for performance.

A second key element in the CSIS methodology is the calculation of real overhead costs, a core shortcoming of past and current cost estimation methodologies. The 12 percent overhead rate used in A-76 (the result of negotiations rather than analysis) is several times lower than the lowest generally acknowledged private-sector overhead rates. Furthermore, overhead rates vary significantly across sectors, making analytically suspect any single overhead rate covering the vast universe of government functions.

The challenge in determining an adequate overhead rate stems from the fact that there is no universally accepted

definition of what costs constitute overhead. CSIS recommends line-item specificity for estimating overhead similar to the discreet, line-item elements of the major A-76 cost components other than overhead. The following line-items should be used to generate an estimate of public-sector overhead for any function:

- Operational overhead – management and oversight
- Information technology
- HR/personnel
- Legal support
- Accounting
- Payroll
- Headquarters management
- Miscellaneous

Line-item granularity also guides CSIS' cost estimation methodology for other cost components. Overall government performance has six major cost components:

- Personnel (direct labor and fringe costs for military and civilian personnel, including health insurance and retirement)
- Material and supply (general, inflation, insurance, maintenance and repair)
- Facilities (cost of facility, rent, insurance, maintenance and repair, capital improvements, utilities)
- Capital (cost of capital assets and

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- depreciation of existing capital assets)
- Overhead
- Additional costs (liability insurance, travel, subcontracts, nonrecurring workloads, minor items, medical exams, training, cost growth, conversion costs, administration and oversight costs)

For the private sector's cost estimate, the base contract price in the bid constitutes the basis, and includes most of the above cost components. Income tax adjustments must be accounted for, as private bids must be credited for the additional federal, state, and local taxes that would be forgone with public performance. Costs incurred by the government for contract administration and oversight must also be considered. Lastly, as with the public side, conversion costs for cases where work is shifted from public to private must be reflected in the private bid.

Final thoughts

The challenge of conducting accurate cost estimating has importance beyond the issue of insourcing. In a time of budgetary strain, the U.S. government must have repeatable, verifiable, and data-driven mechanisms for making decisions and understanding their resource implications, including associated costs. This goes hand-in-hand with the push to bring DoD up to generally accepted government accounting standards. If DoD wishes to justify its resource requirements in a deficit-conscious environment, it must be able to support its decisions with empirically backed figures. The CSIS cost estimation methodology outlined here provides a first step toward this goal. Better access to DoD internal cost data and additional research efforts will be needed to develop a further refined cost estimation methodology.



The Defense Industrial Initiatives Group at the Center for Strategic and International Studies focuses on issues related to the health and governance of the global defense-industrial base. David Berteau is a senior adviser at CSIS and director of the group. Joachim Hofbauer is a fellow with the group, Jesse Ellman is a research associate, and Guy Ben-Ari the group's deputy director.



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