Lexington Institute
1600 Wilson Boulevard | Suite 900 | Arlington, VA 22209
Phone: 703-522-5828 | Fax: 703-522-5837

A "Warren Buffet" Approach to Defense Industry Would Not Include Insourcing

Daniel Goure, Ph.D. May 12, 2011

Deputy Secretary of Defense William Lynn claims that the Department of Defense (DoD) is taking a long-term view of its defense industrial base, one that seeks to ensure that the private sector remains profitable. According to an article in *Bloomberg*, Secretary Lynn is quoted as saying "Think Warren Buffett, not Gordon Gekko." Lynn went on to tell a group of Wall Street investors that "we're in this for the long haul and need industrial partners and financial backers who think and act likewise."

Lynn was trying to stop the rush to the exit by investors who see the winding down of current U.S. wars and increasing pressure for massive cuts in defense spending as signaling a major downturn for the defense sector. The Pentagon's strategy is based, in part, on making strategic choices with respect to programs early so that the contracts that are awarded have a relatively high prospect of being seen through to completion. The strategy also is based on improving efficiencies in the department based on reducing the costs of doing business.

The Deputy Secretary stressed the salutary effect of the profit motive in the defense business and, more significantly, to take greater risks in developing advanced weapons systems. He argued that DoD acquisition reforms focused on ensuring that industry could profit from its efforts but that it would have to have more skin in the game. "What we need is a bit more targeting of risk and profit. . . . You should get the highest profit when you are taking the most risk. I'm not sure the system we have matches those as closely as we'd like to see them. So we are trying to take steps with things like fixed-price development contracts, where we are matching those risks with those profits."

To the department's credit, it is trying to take steps to change its behavior in ways that will make innovations such as fixed price development contracts more likely to succeed. The services have committed to containing their penchant for adding requirements to procurement programs such as the KC-45 tanker and the Littoral Combat Ship.

Another step the Deputy Secretary could take in order to both increase his department's efficiency and reassure Wall Street is to reverse the current drive towards insourcing.

Secretary Gates has already acknowledged that insourcing has not saved money. The principal reason for this is that the public sector does not operate according to the profit-risk equation that Secretary Lynn finds so attractive. The department's recent mania for insourcing came particularly at the expense of very successful performance-based logistics (PBL) agreements that saved the government billions of dollars in maintenance and support of weapons programs.

An additional problem in making the department more efficient may be Secretary Lynn's misunderstanding of the relative time horizons of the private sector versus the public sector. In his statement to investors, Lynn declared that "there is a well-documented tension between companies that have to report quarterly on their financial health and the department that has a five-year plan and thinks in terms of decades." Sorry, but the real problem is that the department thinks in one year budgets and the private companies think in terms of decade(s) long contracts. One reason that costs go up for Pentagon programs is the habit of continually changing their time lines and production quantities. When it comes to PBL agreements industry will tell you that they should be for at least a decade and that the private sector will commit to specific price targets. Program managers tend to dislike long-term PBL agreements because they reduce programming flexibility. With predictability comes the ability to manage risk, make decent profits and provide efficient production and maintenance for the government.

If you invoke the name of Warren Buffet then you ought to abide by the principles that have made the Oracle of Omaha perhaps the most respected business leader in the country. These include investing in quality companies, not overpaying and holding these investments for the long-term. If the DoD adheres to these principles, particularly when it comes to contracting with the private sector, it may even flourish the way Warren Buffet has.