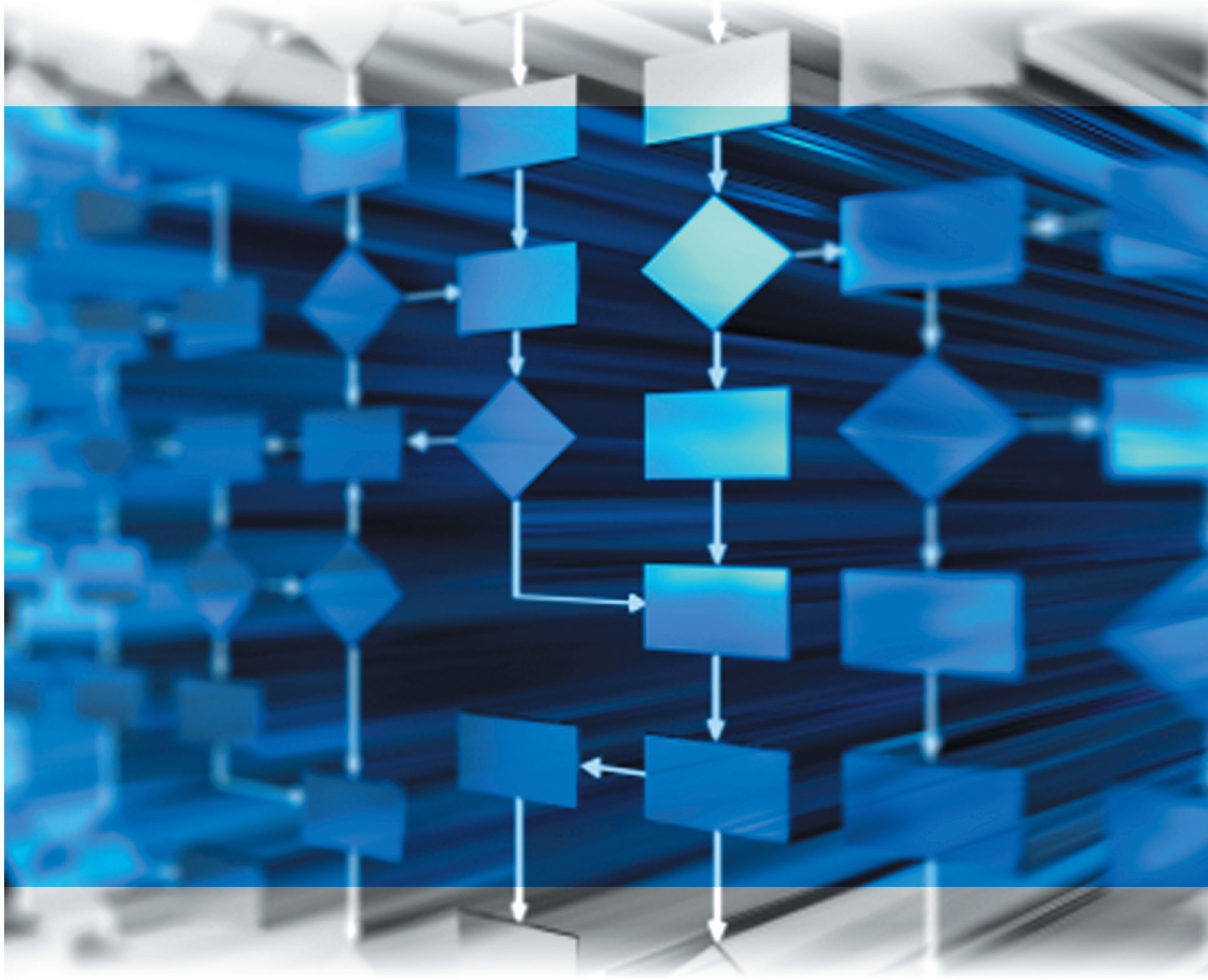
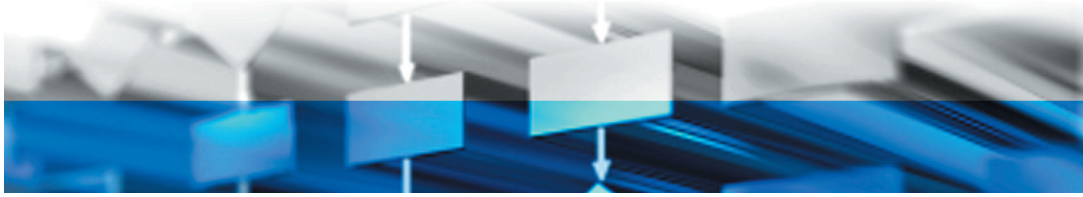
LONE STAR

THE RIGHT ANSWER



Could Cost, Should Cost and Price to Win

November 12, 2011



Could Cost, Should Cost and Price to Win

Dissatisfaction with DoD's procurement system, increased pressure on the Federal Budget, and declining prime contractor prospects have highlighted the need to better understand pricing in defense markets. This paper provides an objective lexicon, and offers some lessons learned bases on years of experience in Decision Analysis, both for contractors and for acquisition officials.

Summary

Lone Star's independent research shows that while technology has accelerated, Department of Defense (DoD) and other Federal procurement has become slower.

Dissatisfaction with Federal procurement, increased pressure on the Federal Budget, and declining contractor prospects have highlighted the need to better understand pricing in government markets. A conversation about "should cost" and "could cost" has been underway for several months, but the concepts involved are still confusing to many decision makers.

Lone Star provides tools and analysis to government agencies and to prime contractors, treating costing and pricing a form of Decisions Analysis (DA). This paper provides an objective lexicon, and offers some lessons learned bases on years of experience.

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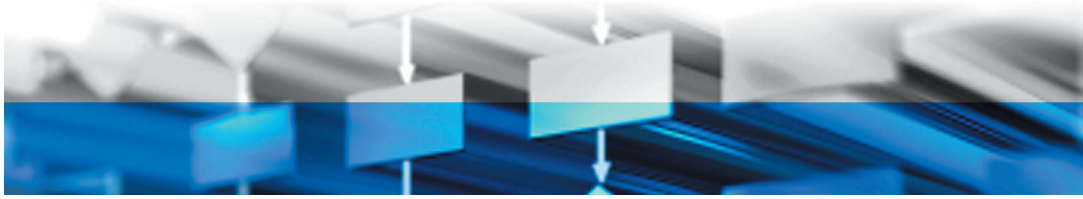
Background

Most Americans make an independent purchase decision before the age of 9. Our consumer economy provides buying experiences long before decision makers enter government service. This experience as individuals is enhanced by more than 200 years obtaining systems and services for the nation. Yet in spite of this seemingly vast pool of knowledge, there is general agreement that as a nation, the U.S. needs improved performance in procurement.

Lone Star's independent research shows that while technology has accelerated, Department of Defense (DoD) and other Federal procurement has become slower. While commercial firms, like FedEx, UPS and Wal-Mart have redefined logistics, federal costs of ownership and support have grown.

One measure of the frustration for both Defense officials and contractors is the number of major procurements which do not result in an award to any of the offerors. While no single problem causes these "misfires", price and price risk are among the issues that kill programs before they start.

As the defense community struggles to deal with budget reductions, a conversation about what things "should cost" has begun. This paper deals with the concepts related to "should cost" and some lessons Lone Star has learned from applying the principles of Decision Analysis.



Objectively Measuring the Price of a Winning Offer

Our research shows raw costs at the prime contractor and price paid by the government are not as well connected as most of the defense community in government and in industry believe.

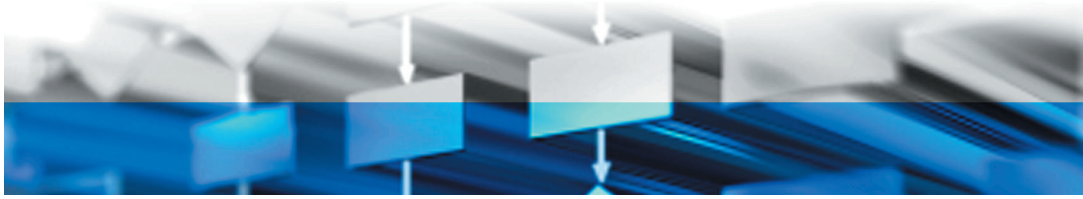
Evidence of the disconnect is beyond the scope of this paper, but our research shows defense markets behave much like consumer markets. Consumer focus groups are routinely shown a product and the group is asked "what do you think this costs?" Often, "baseline" pricing impressions are set without branding. If the group is told a product is made by a luxury brand, the perceived "correct" price goes up. If told it's a "store brand" the "correct" price goes down. Brain science suggests such responses are wired into our brains, creating biases we don't understand or control.

In defense the "right price" may be driven by perceptions about the prime and about the product, which may be created by the buying command's policies, practices and willingness to cooperate with other buying commands. An example is "what should a pound of electronics cost?" Disposable calculators will cost less per pound than an iPod, which will cost less hearing aids. A civil aviation radar will cost less than a similar radar for military aircraft, which will in turn cost less than a space borne radar.

Lone Star's Decision Analysis (DA) work, based on extensive data sets, benchmarking, and our state of the art DA tools has repeatedly provided insight to the linkage between customer actions and market pricing, leading to understand what something "should cost" and, what it "could cost."

Some acquisition reform studies have focused on poor requirements as a root cause of high prices. While this is a valid concern, "gold plating" rarely defines "Should Cost" and "Could Cost." Even when requirements are held constant, pricing can change dramatically. In part because "little r" requirements (how a command choses to buy) can cost as much or more than "Big R" requirements determined by users and the Joint Requirements Oversight Council (JROC). These "little r" requirements drive most procurement page count. These detail which MIL-SPECs and STD's are imposed, what FAR clauses are used, the kind of contract is awarded, and all kinds of administrative processes, reports, and rules. For a given buying command these "little r" issues represent a normal way of doing business. Historical contract costs will be understood in this context.

The "normal way of doing business" tends to create "***Should Cost***" from the buyer's point of view. It is the same thing as a "***Market Win***" from the seller's point of view. These are the results taking no exceptional actions, attracting no new market entrants, and adopting no remarkable innovation. The normal local



market functions as all the participants have come to expect. Competition and negotiation may have some marginal benefit in lowering price, but in many cases, it will actually drive prices up.

In contrast, "***Could Cost***" and "***Must Win***" are the alternative point of view. What *Could* the cost be if an acquisition command were willing to buy in a different way? Is re-competition held too often, or too infrequently? Does the procurement effectively attract (or even allow) innovative approaches? From a prime contractor's point of view, "Must Win" also means the willingness to take exceptional actions in order to win.

It should be clear Could Cost/Must Win can involve risks for the seller, buyer, or both. This is a challenge. Federal procurement systems are risk adverse. Well-meaning rules have built up, with complex layers in the FAR, in each agency, and at each local procuring unit. A large program will undergo dozens of reviews. Often, the reviewers have little understanding of the purpose for the program, product, or service being acquired. Rather, the reviewers seek to avoid risk, and ensure local interpretation of laws, regulations, and guidelines. These reviews kill agility. Generally, the reviewers don't understand their impact on the procurement, and they drive the buyer away from "could cost" and back to "should cost." *These unintended consequences, taken together can dominate the cost to the government.*

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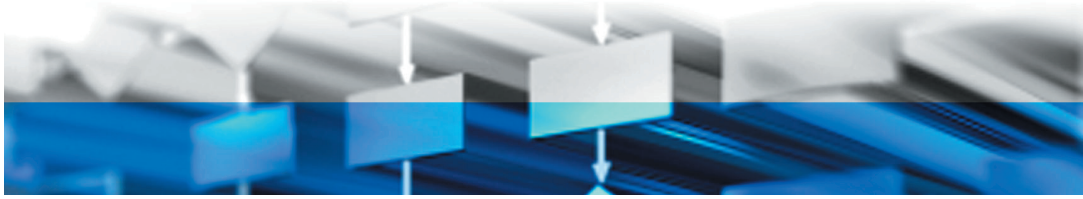
A good part of the risk is the lack of credible financial data about the results of changing from the status quo. *No historical cost data will exist for new approaches whether new contracting strategies or new technology.*

Decision Analysis is a powerful way to cut through this dilemma. Modern DA is based on the incorporation of uncertainty as an element of the analysis process. DA provides a means to incorporate lessons from other programs and commands, as well as from commercial markets, while acknowledging the uncertainty associated with "could cost" changes.

When DA is utilized, either the buyer or seller can better understand how the "normal way of doing business" adds cost, informed choices about how to change are possible. Ironically, the risk often goes down along with the cost, because "normal" does not necessarily mean "lean" or "low risk."

A typical Could Cost/Must Win engagement by Lone Star, for either a procurement agency, or for a prime contractor, includes incorporation of a wide range of information. Sources may include proprietary research, benchmarking outside the normal way of doing business, data from the client, subject matter experts, and in some cases, primary research for the particular engagement.



The data is incorporated into a Lone Star DA model based on TruNavigator™ or StraTable™ (our DA modeling tools). The results are not only the Price to Win/ Could Cost, but also a robust risk analysis and the rank ordered sources of risk and cost.

Achieving "Could Cost" or "Price to Win" involves attacking the status quo while avoiding excessive risk. DA provides the framework for that. Changing becomes possible when decision makers can understand available savings vs. risk, sorted by issue, improving the "normal way of doing business."

Summary

Lone Star's approach to Should/Could Cost is based on lessons learned from years of experience. Pressure on Federal spending is an opportunity to improve benefit/ cost ratios and Decision Analysis provides a means to make these improvements without undue risk.

Lone Star's proprietary research provides our clients with a competitive advantage and with more rapid deployment of DA benefits. Extending academic research to pragmatic measures of costs and benefits, Lone Star has delivered successful DA engagements and models to customers in very complex organizations and to small

Headquartered in Dallas, Texas, Lone Star provides business and technical analysis and advisory services that address client's most complex, mission critical challenges. By utilizing processes based on best practices and tools that enable effective outcomes Lone Star delivers the value clients expect. Lone Star's unique knowledge and analytical capabilities and a client service-oriented philosophy means actionable results are always delivered. Lone Star's roots lie in the development, fielding and support of complex technologies and programs for the Department of Defense and leading enterprises. For more information the Lone Star home page is www.lone-star.com.

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