Big savings from little things:
Non-equipment procurement

Despite constituting a substantial portion of defense budgets, non-equipment purchases tend to receive scant attention. Defense organizations can capture savings of up to 20 percent in non-equipment categories if they raise their game in several dimensions, including capability building, the use of proven purchasing tools and processes, and performance management.

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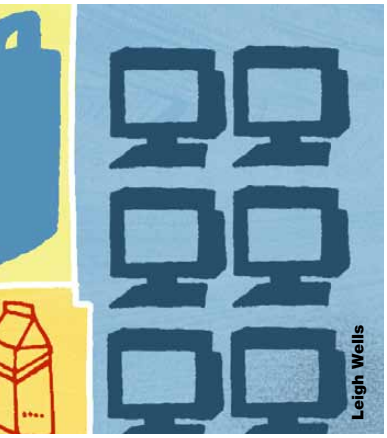
While costly equipment, such as ships or aircraft, understandably receives much of the attention when it comes to defense spending, non-equipment procurement—the recurring purchase of items related to daily operations—makes up a substantial portion of the defense budget. Our analysis indicates that many large militaries spend as much on non-equipment purchases as they do on equipment—that is, up to 25 percent of the defense budget. Non-equipment purchases include civilian-type categories (for example, food and office supplies), military commodities such as simple munitions and helmets, and spare parts for vehicles and aircraft. Non-equipment spend in the 15 largest militaries exceeds $200 billion, more than the GDP of countries such as Singapore or Israel (Exhibit 1).

Non-equipment procurement in defense shares many of the challenges common to public-sector procurement, such as the lack of a consolidated view of spending, limitations imposed by complex procurement laws, and issues with basic performance.[1] These challenges are aggravated by the lack of scrutiny given to non-equipment purchases; decision makers are understandably most concerned about equipment procurement, which represents the "core business" and for which the risks associated with failure are much greater. Furthermore, few people in a typical

[1] See Christian Husted and Nicolas Reinecke, "Improving public-sector purchasing," *McKinsey on Government*, Summer 2009.



defense organization have commercial capabilities in non-equipment procurement. As a result, even basic approaches for obtaining items at lower prices, managing demand, and challenging specifications are not always applied.

Because non-equipment procurement typically does not receive the senior-management attention it warrants, opportunities to achieve savings often go unnoticed. And these opportunities are significant: a number of studies suggest that defense organizations can attain savings of up to 20 percent, enabling them to redirect 2 percent to 3 percent of the defense budget to better uses—without any reductions in personnel or military capacity (Exhibit 2).

Exhibit 1

Big spenders

Annual non-equipment procurement of the world's 15 largest militaries represents more than $200 billion.

	Annual defense spend (2007) $ billion	Estimated annual non-equipment procurement spend $ billion
United States	552.6	110.5
United Kingdom	63.3	12.7
France	60.7	12.1
China	46.2	9.2
Germany	42.1	8.4
Japan	41.0	8.2
Italy	37.8	7.6
Saudi Arabia	35.4	7.1
Russia	32.2	6.4
South Korea	26.6	5.3
India	26.5	5.3
Brazil	20.6	4.1
Canada	18.5	3.7
Spain	17.5	3.5
Turkey	13.6	2.7
Total	**1,035**	**206.9**

Source: *The Military Balance 2009*, International Institute of Strategic Studies; McKinsey estimates

Exhibit 2

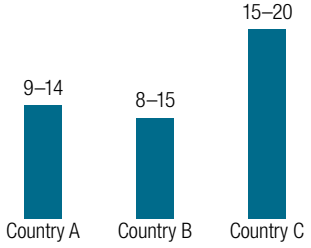
Savings potential

Non-equipment savings can be as high as 20% in some categories.

Examples of specific category savings identified in recent defense procurement projects, %

	Country A	Country B	Country C
Public transportation	12–16		10–18
Vehicles (civilian)		8–12	
Food and catering	8–12	20	14–25
Uniforms and clothing		5–10	10–15
Fuel	5–8	3–5	3–5
Simple ammunition	9–15	10–20	

Overall non-equipment savings identified in defense procurement projects, %



Our work with several military organizations reveals substantial opportunities to better manage non-equipment expenditures. We used a proprietary tool, the Global Purchasing Excellence (GPE) survey, to help military organizations assess the performance of their purchasing organizations. The survey results indicate that non-equipment procurement is undermanaged relative to a benchmark of more than 300 companies: the military average falls near or below the bottom 20th percentile in all but one of the ten survey subcategories (Exhibit 3). We found substantial improvement opportunities in all four performance dimensions covered in the survey: strategic alignment and orientation, capabilities and culture, category management and execution, and structures and systems. In this article, we describe the challenges as well as potential solutions in each of these four dimensions.

Strategic alignment and orientation

Countries use one of three organizational models for defense procurement (Exhibit 4). Each model has advantages and disadvantages.

Exhibit 3

Improvement opportunities

Defense procurement spend is typically undermanaged in comparison to benchmarks.

Procurement managers' evaluation of their organizations' procurement practices, on a scale of 1 to 5, where 5 is best

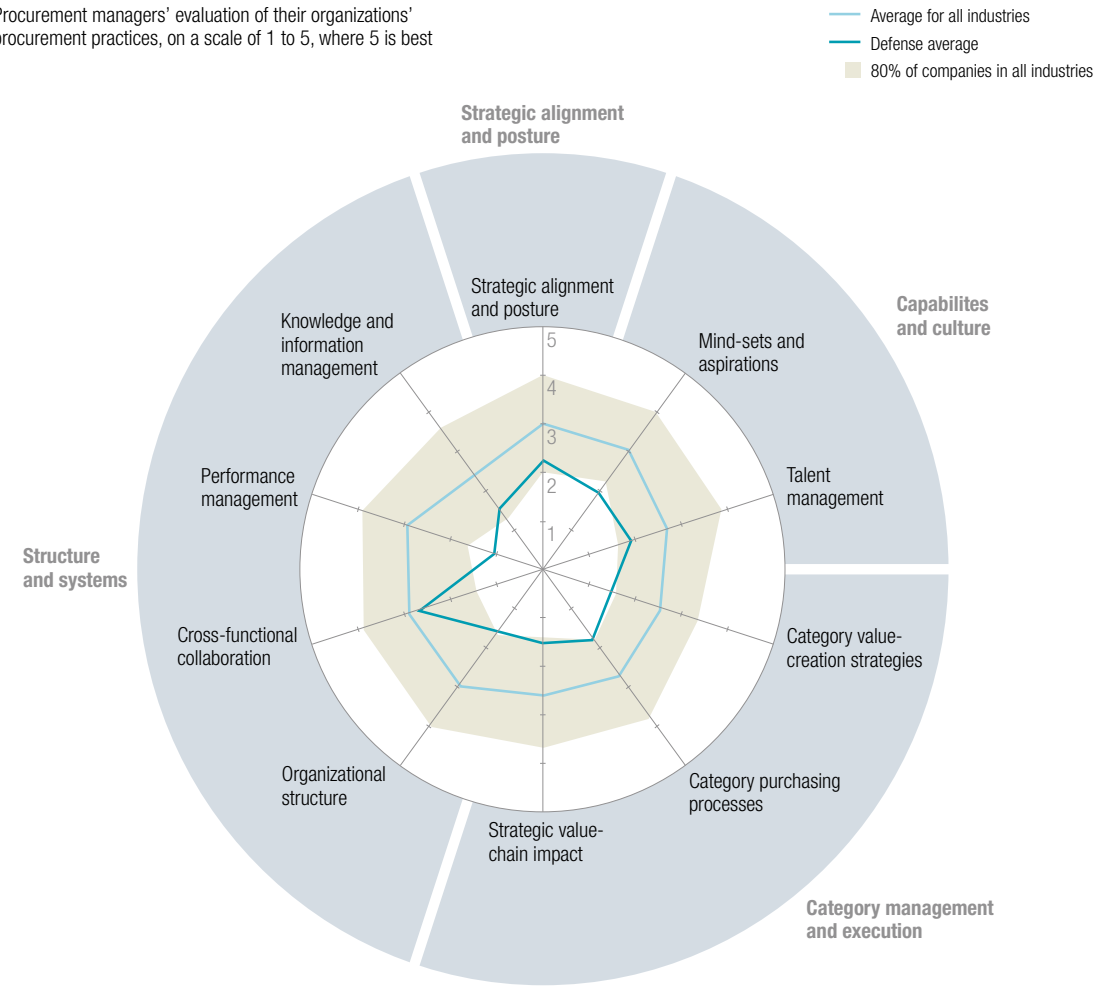
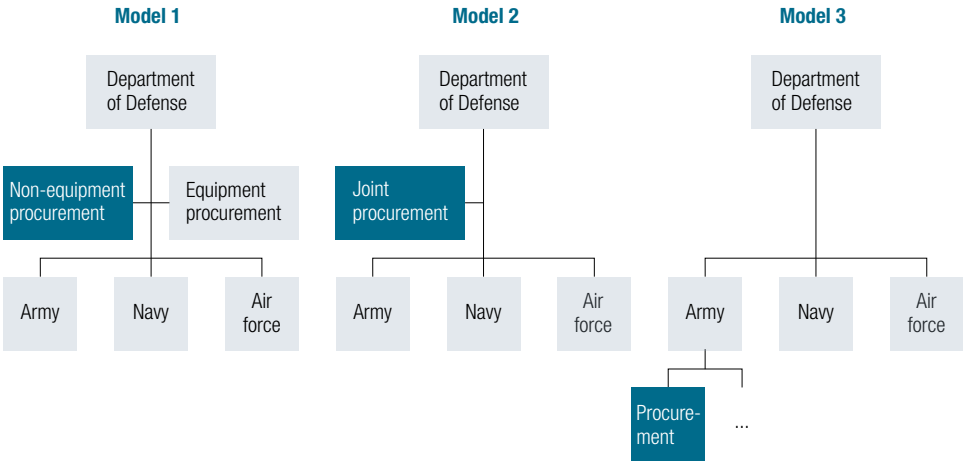


Exhibit 4

Organizational models

There are three options for organizing a non-equipment procurement department.



	Model 1	Model 2	Model 3
Description	Non-equipment procurement is a shared service but separate from equipment procurement	Non-equipment procurement is a shared service, integrated with equipment procurement	Service-specific procurement function, often integrated with equipment procurement
Examples	• Germany • France (certain categories)	• United Kingdom • Israel • Canada	• France (certain categories) • United States

In one model, non-equipment procurement is separate from equipment procurement and is a shared service across all military branches. This model allows the organization to pay adequate attention to non-equipment procurement, hire civilian personnel with extensive purchasing experience, and capture economies of scale. But in this model, the demanding functions or "customers"—the military branches—are separate from the procuring functions, increasing the risk that purchasers will lack a good understanding of users' needs. Also, the procuring function focuses solely on execution and has limited ability to create value by influencing the procurement strategy, challenging product specifications, or managing demand.

The same holds true in the second model, in which a single organization is responsible for both equipment and non-equipment procurement for all military branches. An additional disadvantage of this model is that it tends to result in inadequate attention to non-equipment purchases.

In the third model, each branch has its own procurement organization. This setup increases speed and flexibility in meeting users' needs but often results in unnecessary duplication and missed opportunities to capture scale benefits. It also impedes an organization's ability to get an accurate picture of total spend per category and total spend with specific suppliers—both critical data points for developing a sound sourcing strategy and facilitating effective procurement.

Some countries—including Canada, Germany, Israel, and Sweden—appoint civilian leadership for the procurement organization. Other countries, such as Denmark, France, and the United States, appoint military leadership. While civilian leaders typically have more

Israel: A case study

The Israel Defense Forces (IDF) and Ministry of Defense (MOD) purchase more than $3 billion per year—approximately 2 percent of GDP—in products and services to support defense operations. The defense establishment, in fact, is the single largest customer of many Israeli industries.

For the past 60 years, there has been a clear separation between the demand organization (the IDF) and the procurement organization (the MOD). The IDF defined the need, specified the product and service, and allocated a budget, while the MOD negotiated a price for and purchased the items requested. The separation ensured that military officers did not have responsibility for the commercial aspects of defense operations.

In 2009, the MOD conducted a diagnostic to assess the quality of procurement processes, organizational structures, and outputs in Israel's defense establishment. The diagnostic also assessed the value received for expenditures and the scale of the opportunity for achieving efficiencies. Detailed analyses of six categories covering approximately one-third of non-equipment purchasing identified the potential for annual savings of 8 percent to 10 percent.

The diagnostic homed in on three root causes of inefficiencies. First, the defense establishment lacked a single point of accountability for each category. No function or individual in the organization had visibility into the cost implications of decisions made at each step of the process. Second, the absence of performance metrics resulted in an insufficient focus on cost efficiency. Third, a series of organizational, process, and budgetary barriers impeded efforts to capture scale benefits. For example, the budgeting and ordering processes for some items were on a monthly cycle, limiting the benefits attainable through purchasing larger quantities over the longer term.

The IDF and MOD are piloting several initiatives to address these inefficiencies in four non-equipment categories. For each category, they are creating an integrated category-management team including personnel from both organizations. The team will be accountable for cost, quality, and on-time delivery, and it will have authority over the end-to-end process. The civilian team members from the MOD will be responsible for negotiating with and purchasing from vendors, thereby maintaining the existing prohibition on commercial activities by military personnel. However, the civilian personnel will also work with military team members to develop specifications for the items requested. The MOD is preserving the independence of civilian operations by maintaining existing reporting lines. A function within the MOD's budget department will oversee and challenge the performance of the integrated teams.

The organizations are also establishing performance metrics and targets for savings and customer satisfaction. They are improving the relevant skills of personnel involved in purchasing and category management through on-the-job training and the hiring of experienced civilian personnel. To capture economies of scale, they will make greater use of multiyear budgets and consolidated categories.

To enable implementation of these changes, the IDF and MOD are revising purchasing regulations and standards, conducting a major overhaul of the budgeting process, and redesigning the purchasing organization by appointing a "lead purchaser" to manage each generic category. The government has set a savings target of $250 million per year.

sophisticated commercial capabilities, they may lack credibility with regard to understanding military needs, which can hinder their success in challenging specifications.

Because the organizational model is dictated by issues much broader than procurement efficiency, addressing procurement challenges through large-scale organizational redesign is typically not the first option to pursue. Defense departments can instead focus on two elements to drive effectiveness in non-equipment procurement, regardless of their organizational model.

First, they can establish a cross-functional team, including people from both the military and procurement sides, to oversee each product category. These joint teams would be accountable for setting and challenging specifications as well as procuring items. Defense ministries have found ways to establish joint working teams without compromising the separation of military and civilian responsibilities (see sidebar, "Israel: A case study," p. 38). For example, they require that only civilian team members directly interact with vendors, and they maintain separate reporting lines between the demanding and the procuring functions. Such teams should be relatively small—a dozen people at most—to remain effective.

Second, defense organizations can appoint a sole category "regulator" or "lead purchaser"—that is, a unit within the procurement function that sets standards for purchases within the category. One defense organization had been purchasing 11 types of headsets for the military branches, with varying specifications on cable length, speak/listen functionality, ear-shell design, and electrical impedance. By appointing a category regulator to determine a combination of variants that would meet the needs of all users, the organization was able to set specifications for a single, standardized headset—thereby achieving a savings of 25 percent for the category. While each defense ministry will make different decisions about which product categories to purchase on a branch-specific basis, there are certain categories (for example, food and fuel) that in all cases should be centrally managed because the scale benefits clearly outweigh the need to satisfy different preferences among the branches.

Capabilities and culture

Procurement capabilities in defense organizations are seldom commensurate with the scale and complexity of non-equipment purchasing. Military personnel typically lack a commercial background and, because officers tend to have short rotations in the procurement department, few develop deep

expertise in the area. Moreover, because military personnel do not view non-equipment procurement as an attractive career path, it is difficult to attract and retain the best people. As to culture, defense organizations are primarily concerned about operational preparedness and getting the equipment "right here, right now"—a mind-set that leads to overspecification and lack of standardization.

Building capabilities should be an integral part of all procurement programs. Defense organizations should strengthen capabilities in four critical areas: process knowledge (for example, skills in negotiating and contracting); analytical skills; commodity expertise (that is, for specific items, an in-depth understanding of value drivers, savings levers, and internal demand-management levers); and execution abilities (including defining and tracking performance metrics). Such efforts should emphasize on-the-job training, with classroom instruction kept to a minimum.

One European defense organization paired external experts with motivated internal talent. Through a combination of one-on-one coaching and workshops, the experts trained staff members in procurement skills—for example, equipping buyers with the techniques as well as the confidence to negotiate aggressively with suppliers—thus helping the organization make improvements in category management even after the external experts departed. To embed capability building into the culture of the organization, some procurement functions have set up a daily reinforcement and skill-building system, with talented "champions" within the function serving as coaches.

Hiring civilian talent with extensive procurement experience can also play a critical role in capability building. In many cases, the defense organization is among the largest purchasers in the country, which can make it an attractive employer for procurement professionals. These experienced civilians can help train military personnel and instill a more commercial mind-set throughout the organization.

To attract and retain talent, defense organizations should establish a well-defined career path within non-equipment procurement and offer

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opportunities for moving into and out of the function to build related skills. Detailed job descriptions for each procurement position, including the job's purpose, major accountabilities, and key performance indicators (KPIs), are also essential to track performance and ensure a continuous career-development path. Someone who starts as a local transactional buyer, for instance, should see a clear path toward becoming a regional buyer or category manager, and the steps for getting to those positions should be explicitly integrated into his or her professional development plan.

Category management and execution

There are two main challenges in category management and execution. First, personnel often have limited visibility into the true costs of items—with regard to both total spend and total cost of ownership—particularly across military branches, thus limiting the organization's ability to realize benefits of scale and take advantage of price differences. Second, public-sector constraints, such as strict tender rules, reduce the willingness of personnel to apply the full set of procurement levers. For example, to avoid violating an equal-opportunity rule, personnel might not attend supplier workshops despite the valuable knowledge that they could gain.

To gain better visibility into costs, organizations should get a consolidated view of the overall spend per category. Such an effort will not be straightforward, given that the information needed to create a complete picture of spend will probably not be readily available in the organization's IT systems; many procurement systems in defense organizations contain only an aggregated view for budget purposes (that is, the types of products and services purchased) and item-by-item records of purchases. Procurement personnel will therefore have to estimate the size and composition of these categories by gathering data from a variety of sources, including invoices, department budgets, and current suppliers.

Organizations should apply a total-cost-of-ownership (TCO) approach—that is, they should calculate costs throughout the life cycle of items. In the case of vehicles, for example, this would include garage, fuel, and maintenance costs in addition to the purchase price. Because non-equipment procurement includes spare parts for big-ticket items, the function can play a critical role in managing life-cycle costs for the entire defense establishment.

Once they have the data, procurement leaders should then develop a category-management strategy that includes a sourcing strategy, identification of demand-management levers, and the process for vendor negotiations. They should create clear protocols for supplier interaction (including requests for information and supplier workshops) so as not to unnecessarily restrict the use of procurement tools and methods. And they should streamline

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procurement processes—for example, by setting standards for periodic review of contracts and bid solicitations. One European country captured significant savings by expanding the number of vendors in the tendering process. The procurement staff created detailed specifications for uniforms and bid out the supply contract rather than use its traditional vendor. The resulting contract with a new vendor cut the cost of uniforms by up to 40 percent.

We recommend that organizations first pilot new approaches in categories for which changes will be easiest to implement and that hold significant savings potential. These will typically be the more generic categories in which the military branches are least resistant to change. One European country started its transformation effort in four categories: telephony, canteen food supplies, facilities maintenance, and IT support. For each category, it identified the relevant improvement levers, including product standardization, supplier consolidation, demand management, solicitation of bids throughout the European Union instead of just domestically, and standardized agreements. The total savings ranged from 15 percent to 25 percent in the four categories, and the government is now extending the program to all categories.

Structures and systems

Performance-management systems are often absent or inadequate in procurement functions. In one country, for example, the delivery time for requested items was the sole performance metric for procurement. The lack of KPIs and targets for individuals or for the department often results in limited collaboration among military branches, despite the fact that many defense organizations have established a shared service for procurement.

Some countries outsource non-equipment procurement in an effort to get better prices. However, because third parties are typically compensated based on a percentage of the cost of goods purchased, they have little or no incentive to manage demand or challenge specifications. In the absence of adequate systems for managing the vendor relationship, the defense organization loses the benefits of these two valuable levers for reducing costs.

Defense organizations should establish a performance-management system that makes clear to all personnel what they and the department as a whole must achieve, beginning with aspirational savings targets for each category. Procurement leaders can set these targets by first making top-down estimates based on external benchmarks and then confirming these estimates through a detailed, bottom-up analysis of specific categories. In one defense organization, bottom-up analysis of the clothing category identified savings in the range of 18 percent to 26 percent, comfortably exceeding the benchmark range of 10 percent to

15 percent. Clean-sheet cost analysis suggested that the organization was paying a premium of up to 50 percent for a polyester garrison uniform shirt, for example.

The organization should define a broad set of KPIs for cost savings, quality, and service. Such KPIs might include TCO savings per category, annual and three-year savings, percentage of spend addressed, frequency of using preferred suppliers, advance notice of orders, and internal customer satisfaction, as well as other metrics for demand and supplier management. To hold personnel accountable for achieving these targets, senior management can use tools such as KPI dashboards to track the variance from targets. Consequence management is also critical; the organization should give monetary or nonmonetary rewards for good performance and impose negative consequences for underperformance.

Whenever non-equipment procurement is outsourced, the vendor contract should set clear guidelines and offer incentives for the vendor to manage demand and challenge specifications. For example, the contract could set targets in each category for the vendor to fulfill orders with private-label brands. The contract could also require the vendor to quantify the savings potential for changes in demand-management policies, such as guidelines for travel expenses (for example, how much the organization could save if staff used videoconferencing in place of single-day travel).

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In our experience, it is best to begin the process of improving non-equipment procurement by first addressing a few specific product categories, because quick realization of savings in these categories will help establish credibility within the organization. Early successes will build momentum for addressing more complex issues relating to the organizational structure. Organizational redesign should not, as some believe, be the starting point for procurement transformation, but rather should be addressed over time.

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