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MBA PROFESSIONAL REPORT

**Vertical Integration and the Military –
A Strategic Approach to Outsourcing Decisions of the
Department of Defense**

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March 2006**

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**VERTICAL INTEGRATION AND THE MILITARY – A STRATEGIC
APPROACH TO THE OUTSOURCING DECISIONS IN THE DEPARTMENT
OF DEFENSE**

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Submitted in partial fulfillment of the requirements for the degree of

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VERTICAL INTEGRATION AND THE MILITARY – A STRATEGIC APPROACH TO THE OUTSOURCING DECISIONS IN THE DEPARTMENT OF DEFENSE

ABSTRACT

It is a common belief that government organizations are generally less effective and efficient than commercial entities. Among the prominent problems that need to be addressed in this context is the process leading to a decision regarding how to source activities. Consequently, current publications and laws require government activities to compete with commercial contractors. Also, a preference for outsourcing military activities is often expressed.

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“The struggle of today, is not altogether for today – it is for a vast future also”

Abraham Lincoln, December 3, 1861, American President

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I. INTRODUCTION

“Read not to contradict and confuse, nor to believe and take for granted, nor to find talk and discourse, but to weigh and consider.”

Francis Bacon¹

A. INTRODUCTION

This chapter explains the methodology behind this project paper. It defines the application of expressions such as Vertical Integration (VI) and Outsourcing within the remainder of the study, as well as other terms used. It also touches on the applicability of these terms within the organization of the Department of Defense.

B. METHODOLOGY OF PROJECT

1. Background

With EXECUTIVE ORDER 12526, President Reagan established a Blue Ribbon Commission on Defense Management. The commission was chartered with studying issues of defense management and organization (Blue Ribbon Commission, Appendix 27). In its final report ([A Quest for Excellence](#)) the commission recommended in 1986, among other proposals, “the expanded use of commercial products and ‘commercial style’ competition in the defense procurement process” (Blue Ribbon Commission, Appendix 75). While similar suggestions had been made in 1972, without successful implementation in the defense acquisition community, the commission now stated that substantial changes in procurement policy would be necessary to take advantage of the commercial marketplace (Blue Ribbon Commission, Appendix 77).

Outsourcing was one way of taking advantage of the commercial marketplace that the Department of Defense (DOD) had already practiced for some time. The most obvious area might have been purchases of products for the military. But even as early as the 1960s, the military began to contract logistics and other services to commercial providers. With the end of the Cold War and the rising demand for a ‘Peace Dividend,’ the DOD is more and more looking towards the commercial world to compensate for the

¹ Quoted in [Microsoft Encarta College Thesaurus](#) (1097).

decline of the defense budget. Pressure and increased criticism from Congress forces the DOD to consider commercial business practices to improve the value the military will get out of the appropriated funds. Furthermore, these funds might only be granted in the first place if the DOD can prove that a request not only is essential to the military strategy of the U.S., but also makes business sense. As a society, the military is also becoming increasingly service oriented. Consequently, a growing number of traditionally military activities are being considered for potential outsourcing.

A report by the United States Government Accountability Office (GAO) on Sourcing and Acquisition from 2003 concludes that “it is important for the Department to adopt business practices that will enable it to acquire the systems and services to allow it to operate effectively” (Government Accountability Office, GAO-03-574T 14). The same report points out that:

Government agencies increasingly are relying on services to accomplish their missions. The Department of Defense now spends more than half its contracting dollars acquiring services, about \$77 billion in fiscal year 2001, [...]. In addition, the department reports that it has over 400,000 employees performing commercial-type services. Determining whether to obtain required services using federal employees or through contracts with the private sector is an important economic and strategic decision.

(Government Accountability Office, GAO-03-574T 2)

This strategic ‘make or buy’ decision is governed by the same principles that commercial corporations have to evaluate when facing the identical question. There are several factors to be considered within the DOD that are not dominated by economic rules. The DOD needs to take into account all these considerations when making its choice between a commercial and a military provider.

2. Objective and Research Questions

This MBA paper investigates the rationale behind recent outsourcing decisions in the United States (U.S.) military. It determines if the decisions followed valuable general economic principles and if the decisions were made in accordance with current U.S. laws

and regulations. It further determines if sourcing decisions for the military need to take additional aspects into account that are not covered by economic or current regulatory doctrines.

The examination focuses on the following research questions:

- Are there differences between the military and a commercial company with regard to what influences the sourcing decision?
- Are economic principles applied to the military's sourcing decision?
- Are current laws and regulations adequately addressing all considerations required for the sourcing decision process?
- Are current laws and regulations applied to the military's sourcing decision?

3. Scope and Limitations

a. Scope

The project is intended to analyze the factors that influence the sourcing decisions within the U.S. Department of Defense. It focuses on the applicability of common economic principles as well as on the regulatory tools currently used to control the decision making process.

b. Limitations

The paper is limited to the theoretical principles that generally affect the evaluation of sourcing alternatives at the time of decision making. It does not intend to provide explicit solutions to specific problems nor does it judge whether the chosen examples actually achieved their intended purpose or not. The case examples are referring to these areas: logistics, support, and services for the U.S. military in recent contingency operations, particularly the war in Iraq.

4. Methodology

The study is divided into three parts. First, the generic economic principles behind the sourcing ('make or buy') decisions and the laws and regulations governing the

process are explored by a literature review. Economic criteria are retrieved from textbooks and from scientific articles. Regulatory elements are extracted directly from the appropriate laws, as well as from secondary sources such as implementation guides and legal comments. Second, the rationale for outsourcing recent contracts, using mainly the case of Private Military Firms (PMF) in Iraq, is investigated by using government and civilian publications on the subject, research papers, and especially investigations by the Government Accountability Office. Third, case information is compared to the earlier extracted economic and regulatory criteria to determine if those criteria were applicable and followed. It is also determined if and what additional aspects, such as special military or socio-economic factors, might exist that would affect the outcome of a decision.

5. Organization of Study

The project consists of five chapters. Chapter I provides a short background, explains the organization of the study, and defines necessary terms. Chapter II determines economic factors influencing the outsourcing decision through a review of business literature. It also examines U.S. government publications and regulations regarding the sourcing question for federal agencies. Chapter III describes actual outsourcing decisions within the U.S. military, focusing mainly on contractors on the battlefield in recent conflicts in the Balkans and in Iraq. Chapter IV compares the actual case examples with the economic principles, as well as the government regulations reviewed in Chapter II. Additionally, it introduces and analyzes additional socio-economic issues, i.e., military, political, and legal, that might have an impact on the outsourcing process for the U.S. military. Chapter V contains the conclusion and recommendations.

C. DEFINITIONS

1. Vertical Integration

Vertical Integration:

“Involving all the consecutive stages in the production of goods”

Microsoft Encarta College Dictionary

a. Description

The process that is required to produce and sell a product or service is usually referred to as the ‘vertical chain’ or ‘supply chain.’ Besanko, Dranove and Shanley explain that it “begins with the acquisition of raw materials and ends with the distribution and sale of finished goods and services” (109). A firm that wants to market a certain product or service has to decide whether it is willing and able to perform all the required activities alone, or if it will work together with other firms to achieve this goal. Hart lists two principal ways in which a relationship between two firms can be conducted. The firms could have what he calls an “arms-length” contract, each still remaining independent. They also could merge into a single firm and carry out transactions within the fused entity (Hart C69). It will choose the form that it believes is most beneficial for its future activities. By drawing the limits between performing activities itself or purchasing from independent entities, the firm defines its “vertical boundaries” (Besanko, Dranove and Shanley 109).

A firm that conducts several consecutive activities within its boundaries is considered to be vertically integrated (see Figure 1). According to Porter, the vertical integration defines the division of activities between a firm and its suppliers, channels, and buyers (55). Schmalensee and Willig state two categories of a fully integrated firm:

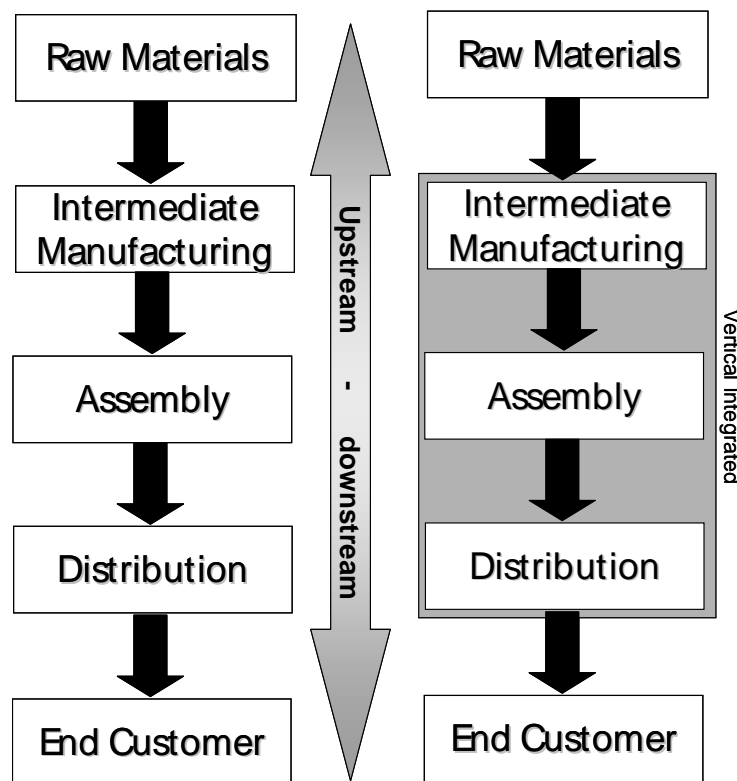
- 1) The *entire* output of the ‘upstream’ process is employed as *part or all* of the quantity of one intermediate input to the downstream process
- or
- 2) The *entire* quantity of one intermediate input into the ‘downstream’ process is obtained from *part or all* the output of the ‘upstream’ process. (185)

They call the case in which “*most* of the output of the upstream process is employed as *most* of the input in the downstream process” ‘partial’ vertical integration

(Schmalensee and Willig 1985). An important determinant of vertical integration is the ability of the firm to make all the important decisions regarding their integrated stages.²

Within the vertical chain, the firms are referred to as being upstream or downstream from each other (see Figure 1). Their relative position is dependent on their performed activities. Early activities in the production are considered to be upstream, later activities are consequently downstream.³ These activities are often sequential, but they can also be performed in parallel. In the case of a lumber mill, the purchase of a forest where trees can be harvested would be an upstream integration. Taking over a retail store selling planks, etc. would be an example of a downstream integration.

Figure 1. Vertical Integration
(After: QuickMBA)



² Compare Schmalensee and Willig: “complete flexibility to make the investment, employment, production, and distribution decisions” (186).

³ Besanko, Dranove and Shanley explain the terminology as follows: “Economists say that early steps in the vertical chain are upstream in the production process, and later steps are downstream, much as lumber flows from upstream lumber forests to downstream mills.” (110).

b. Military Relevance

In a business sense, the military was, and often still is, a very integrated corporation. Especially in the logistics and services sphere, the military used to own all steps in the vertical chain. Even more, the military has its ‘customers,’ the users of the equipment and services also integrated in the same organization. Here the military differs from a commercial firm.⁴ Nevertheless, the terminology of the vertical integration is applicable to both environments.

2. Outsourcing

Outsourcing:

“Buy labor or parts from a source outside the company or business”

Microsoft Encarta College Dictionary

a. Description

The opposite of vertical integration is, in many aspects, deintegration. Slywotzky et al. portray outsourcing as one example for deintegration (compare Slywotzky et al. 100). Outsourcing describes the process in which activities that are required to accomplish the goal of the firm are no longer conducted within this firm. Instead they are contracted with an independent ‘source.’ Rendon refers to “contracting out [...] as the transferring of the performance of a function, previously accomplished in-house, to an outside provider” (16). Consequently, the term often is referred to as the ‘make or buy decision,’ i.e., the question as to whether a required input for a product, which the firm will sell to a customer, should be made by the firm or purchased. It can also apply to services that are required by the firm to help in the process of producing their output.

b. Military Relevance

The military and the government, in general, used to be considered by many as very inefficient organizations. The idea of ‘reducing’ activities conducted by

⁴ Although the commercial world has acknowledged to treat consumers of services and products within the own company as internal customers, there are not too many examples of firms without any external or “...’real’ customers (those who buy our products or services).” (Scott 1).

federal employees has therefore come up frequently. Shapiro points out that “[t]he government has increasingly relied on private means to achieve public ends. [...] While this trend has the potential to improve governmental performance, it also has the potential to cause government failure.”

The military conducts a range of tasks that are not necessarily ‘military’ in nature. Some of these include providing and managing housing or food and a wide variety of other services. The military would give up those endeavors that do not necessarily require uniformed personnel in an attempt to get literally ‘more bang for the buck.’ Consequently, it raises the question to determine what exactly the core competencies of the military are. The Society of American Military Engineers defines outsourcing as follows:

Operation of a commercial activity for the government by a contractor. The government retains ownership and control over operations of the activity through surveillance of the contract. The primary method of outsourcing activities is through cost comparison procedures designed to determine the most efficient and cost-effective method of operation.

3. Privatization

Privatize:

“To transfer to private ownership an economic enterprise or public utility that has been under state ownership”

Microsoft Encarta College Dictionary

a. Description

Privatization constitutes a second example of deintegration (compare Slywotzky et al. 100). It always refers to government owned activities. The government gives up all interest and involvement in the concerned activity. It might not even require the products or services any longer. This distinguishes it from outsourcing, where only the provider of the activity changes. Privatization can be controversial, especially when control of services essential for the public is handed over to a private business. The Office of Management and Budget (OMB) defines privatization as “[t]he process of changing a public entity or enterprise to private control or ownership.” But it “[d]oes not include determination of whether a support service should be obtained through public or

private resources, when the government retains full responsibility and control over the services” (Executive Office of the President, A-76 Supplemental Handbook 37).

b. Military Relevance

The DOD is normally retaining some level of control over the activities it decides not to perform in-house. According to the definition, it is ‘outsourcing’ rather than ‘privatizing’. This paper will concentrate on outsourced capabilities.

4. Further Definitions

a. Value Chain

In contrast to the vertical chain, as defined earlier, the value chain always refers to the activities within a firm. Vertical integration consists of the parts of the supply chain that are within the value chain. Michael Porter defines it in his book Competitive Advantage, as follows:

Competitive Advantage cannot be understood by looking at a firm as a whole. It stems from the many discrete activities a firm performs in designing, marketing, delivering, and supporting its product. ...

The value chain disaggregates a firm into its strategically relevant activities in order to understand behavior of costs and the existing and potential sources of differentiation. A firm gains competitive advantage by performing these strategically important activities more cheaply or better than its competitors.

(Porter 33, 34)

b. Inherently Governmental Activities

‘Inherently Governmental’ is an important definition for government activities, as activities so classified are excluded from the competitive sourcing process. The exact understanding of it is, however, open to some interpretation. Policy Letter 92-1 defines it this way:

As a matter of policy, an ‘inherently governmental function’ is a function that is so intimately related to the public interest as to mandate

performance by Government employees. These functions include those activities that require either the exercise of discretion in applying Government authority or the making of value judgments in making decisions for the Government. Governmental functions normally fall into two categories: (1) the act of governing, i.e., the discretionary exercise of Government authority, and (2) monetary transactions and entitlements.

An inherently governmental function involves, among other things, the interpretation and execution of the laws of the United States so as to:

- (a) bind the United States to take or not to take some action by contract, policy, regulation, authorization, order, or otherwise;
- (b) determine, protect, and advance its economic, political, territorial, property, or other interests by military or diplomatic action, civil or criminal judicial proceedings, contract management, or otherwise;
- (c) significantly affect the life, liberty, or property of private persons;
- (d) commission, appoint, direct, or control officers of employees of the United States; or
- (e) exert ultimate control over the acquisition, use, or disposition of the property, real or personal, tangible or intangible, of the United States, including the collection, control, or disbursement of appropriated and other Federal funds.

Inherently governmental functions do not normally include gathering information for or providing advice, opinions, recommendations, or ideas to Government officials. They also do not include functions that are primarily ministerial and internal in nature, such as building security; mail operations; operation of cafeterias; housekeeping; facilities operations and maintenance, warehouse operations, motor vehicle fleet management and operations, or other routine electrical or mechanical services.

The detailed list of examples of commercial activities found as an attachment to Office of Management and Budget (OMB) Cir. No. A-76 is an authoritative, nonexclusive list of functions that are not inherently governmental functions. These functions therefore may be contracted. (Office of Federal Procurement Policy, Policy Letter 92-1)

See Appendix I for a list of ‘inherently governmental functions’ according to the Policy Letter 92-1.

c. Commercial Activity

Inherently governmental activities must be performed by a government agency. Commercial activities, on the other side, are described by the Circular A-76 as:

[a] recurring service that could be performed by the private sector. This recurring service is an agency requirement that is funded and controlled through a contract, fee-for-service agreement, or performance by government personnel. Commercial activities may be found within, or throughout, organizations that perform inherently governmental activities or classified work.

(Executive Office of the President, A-76)

d. Strategy

Strategy can be broadly defined as “[a] plan that is intended to achieve a particular purpose” (Oxford Advanced Learner’s Dictionary).

e. Strategic Sourcing

Ball’s approach in defining strategic sourcing is focused on the intended outcome of the sourcing decision:

[S]trategic sourcing is knowing what kind of relationship to develop based on market knowledge, the commodity, and the long-term business objectives. It is a sourcing process whereby organizations choose suppliers in a deliberate, calculated fashion. Selection decisions are determined based on factors such as a supplier’s new product development capabilities and capacity to share information electronically, or the ability for a supplier’s component to differentiate the final product. With strategic sourcing, organizations analyze and decide on suppliers based on the strategic impact of potential suppliers and commodities on the organization or supply chain, instead of simply awarding supply contracts to suppliers with a narrow focus on lowest bid.

(Ball)

The U.S. Navy also includes in their explanation the potential managerial or administrative results, by calling it an:

[a]pproach to reducing the total cost of providing infrastructure by conducting a comprehensive review of a business unit or units considering a wide range of options including consolidation, restructuring, privatization, make or buy decisions, adopting better management practices, development of joint venture with the private sector, asset sale, and the termination of obsolete services or programs.

(Navy Strategic Sourcing)

f. Competitive Sourcing

The Office of Management and Budget's understanding of competitive sourcing concentrates on the process, deciding which activity will source a product or service:

Competitive sourcing is the process by which the federal government determines whether functions described as "commercial in nature" are best provided by the private sector, by government personnel, or by another agency through a fee-for-service agreement. The Office of Management and Budget (OMB) Circular A-76 sets the policies and procedures that executive agencies must use to identify commercial-type activities and perform commercial activity competitions.

(A-76 FAQ)

g. Core Competency

Prahalad and Hamel described their understanding of 'Core Competency' in an article in the Harvard Business Review in May 1990 (Prahalad and Hamel). In this article, they declare that a company's competitiveness is a result of its core competencies and its core products. According to them, "[c]ore competencies are the collective learning in the organization, especially how to coordinate diverse production skills and integrate multiple streams of technologies." They especially emphasize the cooperation across organizational boundaries and stress that building core competencies is more ambitious and different from vertical integration. Another major contributor to core

competencies is the people-embodied skills and their allocation. Core competencies are, in Prahalad and Hamel's opinion, a company's critical resource and should be the focus for its strategy at corporate level (Prahalad and Hamel).

h. Agency Efficiency

Agency efficiency will be described in more detail later in the paper. This is the definition by Besanko, Dranove, and Shanley;

Agency efficiency refers to the extent to which the exchange of goods and services in the vertical chain has been organized to minimize the coordination, agency, and transaction costs. [...] If the exchange does not minimize these costs, then the firm has not achieved full agency efficiency.

(170)

i. Technical Efficiency

[T]echnical efficiency indicates whether the firm is using the least-cost production process. For example, if efficient production of a particular good required specialized engineering skills, but the firm did not invest enough to develop those skills, then the firm has not achieved full technical efficiency.

(Besanko, Dranove, and Shanley 170)

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II. THE PRINCIPLES OF SOURCING

“Call a thing immoral or ugly ... a peril to the peace of the world or to the well-being of future generations: as long as you have not shown it to be ‘uneconomic’ you have not really questioned its right to exist, grow and prosper.”

E. F. Schumacher (1911 - 1977) American Author⁵

A. INTRODUCTION

Vertical integration was regarded for a long time by the business world as a very powerful tool that could be used to solve the problems of a corporation. Then, between the end of the ‘60s and mid-‘70s, ‘value chain specialists’ entered the market as new competitors (Slywotzky et al. 99). Consequently, “[c]ompanies began to realize that they could become highly competent in three or four steps of the value chain, but not in twenty. Companies that would try to do too many things would do most of them poorly” (Slywotzky et al. 99). Thus, outsourcing was looked at as the better trend to follow.

For the DOD, the sourcing question is dominated by two considerations. The first is the economic principles that are valid for any market. Current literature presents many questions, arguments, and considerations that are advanced to determine the degree of outsourcing, respectively, vertical integration. The second is the laws, rules and regulations that directly concern the federal government and the military. Those have to be followed by the DOD and are often independent from the economic considerations.

The following chapter examines the cost of the outsourcing decision, grouping the principles into categories and separating the questionable ones from the valuable ones. Furthermore, it will review government publications that govern and regulate sourcing questions.

B. ECONOMIC ARGUMENTS CONCERNING THE SOURCING QUESTION

1. The Direct and Indirect Cost of In-house Activities

Whatever the expected benefits are that a company will receive from the decision to outsource an activity, the decision always comes with certain associated costs or

⁵ As quoted in the Concise Columbia Dictionary of Quotations (185).

savings. The calculations might also look different, depending on the fact of whether a business makes the decision for an existing activity, or if it needs to acquire an altogether new capability. But before being able to compare costs with benefits, the company must realize in what form these costs can occur.

a. Direct Cost

Some costs can simply be expressed in the form of the dollar amount spent if the activity is not outsourced. Sometimes substantial investments are required to develop or improve a capability within a company. Adam Smith implies the requirement of “up-front investments of time and/or money to develop special skills” (Besanko, Dranove, and Shanley 119). These investments often involve ‘fixed capital,’ according to the authors, which remains the same, even if demand decreases after the investment has been made (119). High direct costs, therefore, make outsourcing more favorable. In contrast, Buzzell points to the high capital requirements of integrating new operations into a firm (94). Outsourcing transfers some of these costs and risks to the company to which the activity is contracted. This increased risk is very likely to be reflected in a higher price which the contractor will charge for its services or products.

b. Opportunity Cost

If the decision to outsource concerns an already existing capability, the firm has to recognize opportunity costs (i.e., the value of a foregone opportunity). The opportunity cost of keeping the activity in-house is the value of selling the assets. If it decides to outsource, the firm has the choice to sell or not to sell the assets associated with an existing activity. Any cost that originally was incurred by developing or maintaining a capability in-house that can not be sold for profit, should be considered ‘sunk cost’ and is therefore not relevant. In any case, the firm should only include future costs or savings in their analysis. Unless relationship-specific benefits exist which are not available to other potential buyers, benefits should offset costs.

c. Flexibility

Substantial investments by a firm that is or remains vertically integrated can have a significant impact on that firm's future flexibility. The integration reflects the firm's commitment to conduct its business in a certain way (Buzzell 94). This could leave the company without enough flexibility to adapt to changes in the market without additional high costs. Market transactions might be more responsive as the firm can pick the provider that is most likely to deliver according to the new requirements. Grant argues, on the other hand, that "where system-wide flexibility is required, a vertically integrated set of activities may offer a more effective means of achieving simultaneous adjustment at every level" (323, 324). When considering future flexibility, the firm that faces the outsourcing decision also needs to evaluate the level of bureaucracy that the chosen solution will face.

d. Transaction Cost

Any legally binding contract includes a promise (e.g., to provide a good or service) and consideration for that promise, usually in the form of payments to the contractor. Additionally to these obvious expenditures, other costs arise. Brickley, Smith, and Zimmermann agree with Ronald Coase who argued that market transactions are not costless (521). Examples of these 'transaction costs' are the search for a supplier, negotiating a price, opportunity cost of time, legal fees and so forth (Baye 205). Other transaction costs can result from different information between buyer and seller, unclear property rights, improperly enforced contracts and concerns of being taken advantage of (Coughlan).

If a company has not outsourced an activity, the internal transaction costs may be less obvious. But even within one company, the actions to set up and coordinate the transfer of a product or services from one business unit to another are not without cost. Besanko, Dranove, and Shanley include the adverse consequences of opportunistic behavior in transaction costs (134). The authors argue that the impact of these costs must be evaluated against influence costs, which essentially include all costs that are incurred within a company when organizing transactions internally, including the costs of bad

decisions (125). Examples of such influence costs are: allocation of resources to one division results in fewer resources for other divisions; lobbying time by division managers to influence central management towards a certain decision; costs resulting from bad decisions. Besanko, Dranove, and Shanley also predict that, compared to a larger integrated entity, a smaller independent firm might be more likely to avoid influence cost (125).

e. Control

For many companies, long term customer relations, brand name recognition, and a positive reputation are important factors in keeping up demand. These firms are willing to invest significant amounts to maintain these factors; for example, through advertising and quality/process controls. If some of the activities are outsourced, the firm loses part of the control over such factors. Brickley, Smith, and Zimmermann point out that hiring less skilled labor might help to cut costs for the retailer but also incurs costs in the form of less customer satisfaction. These costs are only in part born by the retailer. As long as he is also selling products from other firms, and especially if he is not depending on returning customers, the retailer has no great incentive to invest as much into the reputation of one product or service. This is called the ‘free-rider problem.’ The cost to the business that outsources lies in the reduced demand due to lost customers. If the firm is vertically integrated, the potentially damaging activities are within their control and probably without competing products. The incentive to maintain the reputation of the firm is therefore significantly higher, as the success of the activity depends on this reputation more than if outsourced.

Risk is associated with vertical integration and outsourcing. If the firm decides not to outsource, difficulties that arise at the integrated stage could impact performance and profitability of other stages (Coughlan).

2. Questionable Economic Motives for Outsourcing

Some arguments used to justify either of the decisions, outsourcing or integrating, are not always valid if just considered on their own. Some of the reasons might be an

incentive to start thinking about outsourcing or an indicator in which direction the ‘trend’ is going. If, for example, many other firms in the same business sector are outsourcing, a company might find it worthwhile to investigate this choice. But it should only actually do so if the concrete business analysis proves outsourcing to be the better choice, not because it has become the business norm. The firm should not go that way simply because ‘everyone else is doing it’ (even if it could be the right choice for everyone else).

a. Economy of Scale

Besanko, Dranove, and Shanley claim that a company with a large market share would gain more if it does not outsource (173). They argue “[t]his is because the more the firm produces, the more its demand for the input grows and the more likely it becomes that in-house input production can take as much advantage of economy of scales and scope as an outside market specialist” (173). The capability to perform an activity on an efficient scale is only a prerequisite for vertical integration, not its justification. In terms of economy of scale, it seems to be more important that capacity and requirements are in balance, rather than that a business be able to perform on a larger scale. If the in-house capacity is not in balance with the other stages, the firm faces excess supply or demand. If it cannot buy or sell the extra capacity for a good price on the market, it is wasting money by integrating. If the firm is able to buy or sell the extra for a good price, it shows that the market for this product works well. In that case, the firm has to answer the question why it believes it is better off by integrating this activity instead of using the market. It also has to consider that it might be buying shortage from or selling excess to its own competition and whether this is practical or advisable.⁶

b. Lower Input Costs

Another argument often quoted is that outsourcing results in a higher price for inputs than if the stage that produces the input were vertically integrated into the firm.

⁶ This assumes that any products a firm requires as input for its activity or produces as output by this activity are similar/the same as the products its competition would use. A lumber company that produces excess wood in its forests would most likely be selling that wood to other lumber companies, i.e. to its competition.

The idea behind this line of reasoning is that, when integrated, the firm could acquire the input ‘at cost,’ i.e., without the profit that would be pocketed by an independent supplier. If the stage is integrated, the cost of producing the input is most likely to remain the same as before. If the firm does not charge the profit to its internal business elements, it forfeits a profit at an upstream level (that it could make if it would sell the input to a different company) for the profit it makes downstream (by selling the product that includes the input). Additionally, the firm is stuck with the upstream stage supplier if input costs fall. If the costs decrease enough, the business case that led to the decision not to outsource may no longer be valid.⁷

c. Assurance of Supplies

Similar to the reasoning above, what is often mentioned in business literature is assurance of supplies. It is under rare circumstances that vertical integration can provide inputs that are otherwise unavailable to the firm, potentially even at better cost. This could only be the case if the resources are extremely scarce or come from a sole supplier who, for one reason or another, does not want to sell to a firm or charges it higher prices than its competitors.⁸

d. Lack of Internal Capabilities

One opinion states that a firm should outsource a capability that it does not possess, or that the market can perform better. Grant, for example, alleges that “the lack of specialization inhibits the development of individual capabilities” (323). The boundaries of the firm or the business could also change. One such example is the emergence of the requirement that nearly every firm, no matter what business it is in, employs some sort of information technology (IT) support. This is a new capability that the firm needs to possess and it has to decide where to get it from. But, again, the primary question here should be why the business does not have the ability to perform the activity on the required level (in terms of effectiveness and efficiency). Determining

⁷ Compare Besanko, Dranove, and Shanley for a case example (114).

⁸ Compare Buzzell’s example from the petroleum industry (93).

those reasons will help to decide whether the firm should be developing the ability in-house, or soliciting it in the market place.

e. Increased Profitability

Finally, even the simple argument of increased profitability can be problematic. If, under current conditions, one option appears to be more profitable, the firm needs to find out why that is the case. While more profit is surely desirable by the firm, the firm might be able to find an even more lucrative solution by adapting its operations. As nothing is one hundred percent predictable, the risks of the decision also must be included in the calculation, as well as the long term impact under variable circumstances.

3. Valuable Economic Motives for Outsourcing

There is a variety of valuable and helpful indicators by which a firm can determine whether it might be advantageous to outsource or if it should stay with an in-house capability:

a. Market Conditions

Competition promotes market efficiency and thus lower prices.⁹ As a consequence, a firm that wants to outsource an activity to a competitive market is more likely to save costs than if the market is not competitive.

⁹ Compare with Brickley, Smith and Zimmermann (519).

Also, a declining or consolidating market could lead to independent suppliers leaving the market, as they do not expect to make sufficient profits any longer. The resulting consolidated market conditions no longer necessarily provide the lower prices discussed above, and may make integration more attractive. A firm facing those changing circumstances needs to evaluate why the market is declining. Only then can the firm determine if it should integrate or outsource. As one can assume that companies don't leave a market for baseless reasons, the firm also must decide if the same reasons could affect its own activity in the future. Obviously, if market conditions change so unfavorably for the input, the firm should consider leaving this market altogether. With regard to the military, the case could be more difficult. Often depending on old technology or services rarely used by anyone else, the military cannot afford to just leave a market if conditions become unprofitable. They might need to vertically integrate (or not outsource in the beginning) if they are depending on the input and no one else is willing to provide it.

b. Market and Bargaining Power

If a firm considers outsourcing an activity, it needs to consider the leverage of the companies in that stage and the influence its own decision will have on the current state. The decisive factor is the relative market power, rather than the absolute, between the actors. While a company might be a very dominant player in the market, its leverage compared to another powerful firm might only be minimal.

If the market or bargaining power of the buyer is higher than the suppliers, it will have positive effects on the cost for the firm. In that case, the downstream firm might be better off outsourcing the activity.

If a dominant firm is currently not present in a stage, it could increase its bargaining power by threatening to enter it. The firms presently operating in that stage might consider it more beneficial to remain in the present customer/supplier relationship. As a result, they might offer better conditions for future contracts in order to prevent the firm from integrating into 'their' stage. Obviously the intent must be sincere, or at least the threat must be perceived by the other firms to be genuine.

On the other side, a dominated business might find it attractive to enter the dominating industry in an attempt to reduce the leverage of that stage (Stuckey and White 75). Saloner, Shepard, and Podolny claim that vertical integration could mitigate the power of other segments (254). But the cost of the required investments to achieve a shift in the balance of power might be prohibitive. Moreover, the outcome is only a prediction, which also has to predict the reaction of the incumbent companies to the new entry into their market.

The firm, as well, needs to avoid giving extra leverage to other companies with which it is negotiating. It might lose a considerable amount of bargaining power when not having a consolidated strategy for all components of an outsourcing contract. A firm that just bought some equipment from a manufacturer has less bargaining power for a maintenance contract (as it obviously needs that contract to service the machine it already purchased). McGahan points out that the timing of negotiations can affect the potential hold-up costs and the risks of specific investments (9).

c. Source Dependencies

If a firm is vertically integrated, it can be assumed that it will satisfy its need for inputs mostly from internal business elements. Especially, if significant investments were made into the integrated element, it is not desirable to additionally use sources outside the company. Grant argues that this constitutes a compounding risk, as problems at one stage can threaten production and profitability at the other stages (324). It will leave the firm either without suppliers or buyers, or it makes it necessary to use independent contractors at, very likely, high prices. Outsourcing can mitigate that risk, but only if there is a competitive market or at least multiple sources available. If there is only one company to outsource to, the situation is not much different from one internal source.

d. Competition with the Firm's Own Suppliers or Buyers

The degree of vertical integration of a firm can determine how it is being viewed by other companies with regard to competition. While a firm might be looked at

favorably by its suppliers or buyers, this perception can change. If the firm vertically integrates into other stages, those companies can regard the firm now as a competitor. Consequently, it might make “independent suppliers and customers less willing to do business with the vertically integrated company” (Grant 323). The new conditions might have a significant influence on the outcome of the analysis of the benefits of outsourcing versus in-house capability.

e. Relationship-Specific Investments

To fulfill a contract between two firms, one or both might be required to make investments. These investments can be the procurement of new assets, transfer to a certain location (collocation), or hiring of personnel. If the investment has no alternative use other than the current buyer/seller relationship, they are regarded as relationship-specific.

When production of inputs involves investment into relationship-specific assets, outsourcing might be the less attractive alternative (Besanko, Dranove, and Shanley 174). There is the question of control. If the assets are owned by another party, the firm may get to use the products, but it cannot execute the ultimate authority over the assets and their use.¹⁰ As contracts are generally not regarded to be complete (i.e., do not specify the appropriate reaction for every single possible situation), they do not provide the same security as ownership. Moreover, the contractor might be afraid not to recoup his investment into a relationship-specific asset. He, therefore, could charge a high price (to ensure a recoupment under the current contract or the follow-on) for his output.¹¹ Additionally, a contractor might leave the market if the relationship-specific investment becomes too large.

The firm can evade these dependencies by not outsourcing tasks that require large specific investments. Alternatively, it can provide incentives for the supplier to make the investment. These incentives could include sharing of long term plans in order to allow the supplier to plan more effectively for changes. The firm could

¹⁰ Compare the example of PepsiCo bottlers by Besanko, Dranove, and Shanley (177 – 178).

¹¹ Compare with Vining and Globerman (11 – 12).

share benefits from changes with the supplier (who partly made them possible through his investments into his relationship-specific assets). Also, the firm could negotiate long term contracts to assure the supplier of their long term commitment.¹²

In case of outsourcing, the value chain will only remain stable, despite the requirements for investments, if both partners are better off remaining in a business relationship.

f. Coordination and Management within the Stages of the Value Chain

As mentioned earlier, relative market power is more important than absolute. This requires a synchronized flow of production throughout the whole chain. For obvious reasons, an integrated firm can more easily achieve this (Besanko, Dranove, and Shanley 127). Decisions that directly depend on or impact other decisions in the chain are easier to coordinate within one firm. Business elements of one firm are also less likely to have to pay attention to interests of other customers.

A counter argument is that some businesses might be so specialized that they do not have the expertise to manage other stages in their value chain. Grant gives the example that FedEx could theoretically produce its own trucks, but that the management systems and organizational requirements between the two segments are too different (besides the obvious questions regarding economy of scale and low transaction cost in purchasing trucks) (322). Consequently, the firm might be better off outsourcing an activity instead of acquiring the management capabilities. The less able a firm is to achieve this internal integration (agency efficiency), the more it is better off outsourcing the activity (Besanko, Dranove, and Shanley 170). If the firm indeed wants to outsource these activities, it must make sure that the contracts reflect their need for integration. According to Besanko, Dranove, and Shanley, incentives and penalties can help to avoid bottlenecks caused by contractors. If a business element has a cyclic demand and/or

¹² Compare with Brickley, Smith and Zimmerman (533).

supply, outsourcing can be an advantage as the firm does not need to manage an integrated capacity at the low periods of the cycle. It also can outsource only the excess capacity at peak times.¹³

g. Taxes and Regulations

Government taxes and other regulations are also a form of transaction costs. Brickley, Smith and Zimmermann argue that profits can be shifted from one business element to a low-tax activity by charging higher transfer prices (526). Thereby total taxes might be reduced. The same might work for profits within a regulated activity. Outsourcing might subject a firm to some of these taxes and regulations it was avoiding when it was integrated.

On the other side, outsourcing could help a firm to evade regulations that prevent it from directly being active in a business element. For example, a firm could outsource to a local company in a foreign country if laws there prevent the activity of businesses from outside the country.

h. Information and Property Rights

Firms might want to keep certain knowledge regarding their business private. This would normally be anything that gives this firm an advantage in the market (Besanko, Dranove, and Shanley 132). Unless this information is protected, e.g., by a patent, other firms might be able to use it to capture value from that firm. It would be, for example, significantly cheaper for a pharmaceutical company to copy a competitor's formula for a drug and it could, as a result, sell the product cheaper. The company that originally developed the formula could not be profitable at the same price, as it needs to recoup its research costs.

Outsourcing could require the provision of some private data to the contractor.¹⁴ There are several potential negative impacts of this practice. The

¹³ Compare business school example given by Besanko, Dranove, and Shanley (129 - 132).

¹⁴ There is a possibility that a company can capture value from the DOD, e.g. by gaining information about the highest price the government is willing to pay for a product and using that information in their proposal.

proprietary data could be used by the contracted company to improve its own capabilities (reducing its own research investments) and become a competition to the outsourcing firm. The contractor could also sell the information to a competitor of the outsourcing firm, or other interested parties. Additionally, other parties could gain access to the data through the contractor by accident or neglect. Consequently, the firm needs to make sure that others cannot gain access to important information.¹⁵ If this cannot be guaranteed, the firm might be better off integrating that capability.

C. GOVERNMENT REGULATIONS CONCERNING THE SOURCING QUESTION

Congress has passed several laws that sanctioned the use of commercial services and products. “The longstanding policy of the federal government has been to rely on the private sector for needed commercial services” (Executive Office of the President, A-76 1). A variety of documents have been published providing government regulations and policies regarding how federal agencies are to implement this policy. Among them are the Federal Acquisition Streamlining Act (FASA, 1994), the Federal Acquisition Reform Act (FARA, 1996), the Information Technology Management Reform Act (ITMRA, 1996), and the Federal Activities Inventory Act (FAIR, 1998). The two most important regulations are paragraph 2461 of U.S. Title 10, which provides the basic rationale behind competing the sourcing of an activity, and Circular A-76, which provides detailed instructions on the process.¹⁶ For the DOD, all branches of the military have published regulations, providing implementation for the respective service as well as general guidance and experiences with the process.

¹⁵ For obvious reasons, the DOD has not only to be afraid of proliferation of commercial data but also of information relevant to national security. Information systems of defense contractors, containing government and their own sensitive data, can be more vulnerable to attack than those of government agencies. Compare with O’Hara Defense Contractors May Be Chink in Cyber Security.

¹⁶ The A-76 circular represents an implementation of the FAIR act of 1998. As the circular contains the same requirements as the FAIR act, but is more detailed, it is used in this paper as a reference.

1. Circular A-76 ‘Performance of Commercial Activities’

This circular by the Office of Management and Budget (OMB) is valid for all government agencies, including the military departments as defined in U.S. Code 5, paragraph 102 (i.e.,: Department of the Navy, Department of the Army, Department of the Air Force), except as otherwise provided by law. It requires all agencies to identify ‘commercial activities’ within their organizations, and then subjects the performance of these activities to the forces of competition to ensure that the American people receive maximum value for their tax dollars (1). A-76 then describes how federal agencies are to achieve this goal.

It is determined in the source selection process which factors need to be included and how much weight is given to each of the criteria. Socio-economic factors are only considered when required by law. It is left to the Source Selection Authority (SSA) to think of all potential impacts that their decision will have.

While some of the instructions are very detailed, only current or future costs of the performance of the contract to be awarded are considered. There are no provisions to include, for example, the cost of previous training of government personnel or the concept of opportunity cost. It is hard to predict exactly the cost that will occur if an incumbent agency is not selected, especially since civilian government employees are not easily fired or transferred. The agency must either find new jobs for them or provide incentives for them, such as voluntary separation payments.

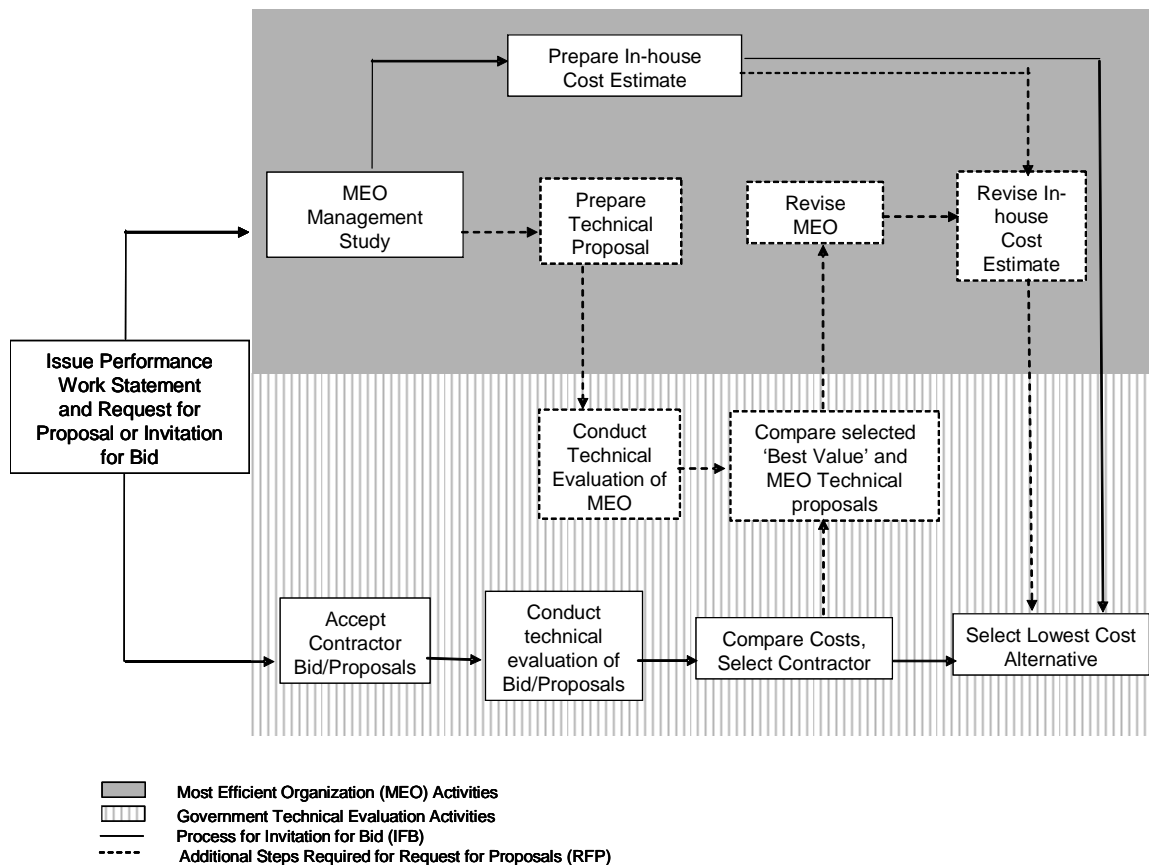
No factor seems to be included to determine the effect on employees or agencies that were only supporting an activity part-time and that might be left without a sufficient workload if that activity is outsourced. Overhead costs are part of the calculation, however, only with a standard factor. The exact impact of an activity on the overhead for the affected government agency is not determined.¹⁷ The economy of scale for the government activities is also no consideration in the decision process. Figure 2 provides an overview of the process as described by the GAO.

¹⁷ It cannot automatically be assumed that the overhead is reduced by the exact percentage of work that will be outsourced. In the worst case, the overhead might remain the same, thereby just increasing the proportion of overhead for the remaining government agencies.

All competitive sourcing must be reported quarterly. Also, the agencies are required to monitor the performance of the contract. Past performance can be a factor in future selection. The contract can be extended through options, but only to the maximum performance period as stated in the solicitation (Executive Office of the President, A-76 B-19). At the end of the last performance period a new competition must be conducted. A-76 also has no explicit requirements to document the farther reaching impacts, beyond execution of the contract, of the sourcing decision.

The following are the main criteria that A-76 requires to consider when deciding how to source an activity.

Figure 2. The A-76 Process
(After: Government Accountability Office, GAO Report GAO/NSIAD-99-44)



a. Only Commercial Activities Can Be Outsourced

To decide the sourcing question, the circular first of all distinguishes between inherently governmental activities, which cannot be outsourced, and commercial activities which should be competitively sourced. In order to determine into which category a government function falls, A-76 requires each agency to annually submit the following information:

- (a) an inventory of commercial activities performed by government personnel;
- (b) an inventory of inherently governmental activities performed by government personnel; and
- (c) an inventory summary report. (A-76 A-1)

For all billets that are defined as inherently governmental, this classification must be justified in writing, using the principles outlined in Policy Letter 92-1 (see Chapter I 4. b. – Definitions) and additional provisions in A-76. If the classification of billets is not challenged, the functions will be executed by government personnel.

b. Activities that Could be Outsourced Must be Competed

In order to award an activity, the work to be performed needs to be competed fairly. A-76 and other government conventions such as the Federal Acquisition Regulation (FAR), regulate in detail how the competition needs to be conducted to be fair. The competition is open to all qualified bidders, including the incumbent government activity or other government organizations. This stands in opposition to one of the assumptions stated by Grasso’s CRS report on A-76 policies. She presumes “[t]he federal government should not compete against its citizens” (CRS-3). A relatively wide variety of regulations allow exceptions to this rule regulation, i.e., sole source contracts.

This requirement reflects economic motives as described under ‘Market Conditions’ and ‘Source Dependencies.’ It also touches on the problems of relationship specific investments. To achieve the desired effect, it also assumes that more than one source is available to perform the activity.

c. Provider Performance Must Be Technically Acceptable

A-76 requires that the source selection authority evaluate the technical acceptability of any offer (B-13). Only offers promising to fulfill the requirements, as stated by the government, can be considered for outsourcing. Trade-offs in capabilities is possible and need to be evaluated by the SSA (B-15).

d. The Lowest Cost Provider Must Be Selected

The government prepares a Performance Work Statement (PWS) which describes the tasks and requirements, focusing on results or outputs (Executive Office of the President, A-76 Definitions). The government then defines the ‘Most Efficient Organization’ (MEO), i.e., the optimum government organization to perform the activities of the PWS. Consequently, an In-House Cost Estimate (IHCE) is developed to reflect the cost that would be incurred by the MEO.

A contracting officer (KO) will conduct a solicitation process to obtain offers by civilian companies to perform the activities, based on the PWS. A-76 details which costs need to be included and by which factor they are weighted. This allows comparing the costs of the different competitors (see Appendix III for an excerpt from A-76 with the appropriate table). After evaluating the offers, the KO will chair a board that will select the ‘best value’ or the ‘lowest price technically acceptable’ offer.¹⁸

Finally, the IHCE will be adapted so it reflects the cost that the MEO would incur if it would deliver the same performance as the ‘best value’ contractor. In comparing the two providers, the ‘lower cost’ offerer needs to be chosen. “The procurement of supplies and/or services from the private sector must be based upon a cost

¹⁸ According to FAR 15.101, the ‘best value’ offer is chosen when not the relative importance of the price, but other factors, is dominant for the decision (e.g., technical performance).

that is lower than the cost at which in-house personnel can provide the same supplies and/or services” (Army Publications Directorate, Army Regulation 5-20 Para. 1.5).

2. U.S. CODE Title 10

This US law has provisions regarding sourcing decisions, especially within the DOD. In paragraph 2461, it prohibits the outsourcing of a government activity to a private company before the DOD has issued a report that analyzes the effects of the outsourcing. It even mandates a report on the cost of the analysis (2461 (b)).

The depth of the analysis required goes beyond the A-76 circular. It does also include economic and military implications. The formulations of these requirements are extremely broad without further details or guidance as to what should be included. Additionally, it is only mandatory to conduct the analysis. There are no recommendations about if and how the findings should be considered in the actual decision process. This might be a reason why some are not part of the A-76 requirements.

Besides the cost comparison between government and private performance of an activity, as in A-76, the following information is required:

a. Estimate ‘All Other Costs and Expenditures’ of Outsourcing

The provision requires providing an estimate of “all other cost and expenditures that the Government would incur” because a contract to a private company is awarded (2461 (b)). There is not much further detail about what these considerations should include. While this statement allows the decision makers to include everything they consider important, it is also a very broad claim that does not give good guidance to anyone involved. With regard to the economic principles, this requirement reflects many of the principles mentioned earlier, especially the need to include all transaction costs and other direct and opportunity costs.

b. Examine the Potential Economic Effects of Outsourcing

Besides actual costs, the analysis also has to consider the potential economic effects that an activity being performed by the private sector has on DOD

employees, and the government and the local community (if currently more than 50 federal employees perform that function) (2461 (b)). This is, again, a very broad formulation that requires economic expertise and thinking of the decision makers without determining any boundaries for the considerations. The requirement goes beyond considering the costs described in the previous paragraph and other factors restricted to the directly affected activity. It needs to take into account the impact on other agencies within the government, the defense industry and market conditions in general and competition with buyers/suppliers in particular.

c. Examine the Potential Effects of Outsourcing on the Military Mission

In deciding the sourcing of an activity, the impact on any military mission which is associated with the activity has to be determined (2461 (b)). This is actually the only criterion that introduces military operational aspects (as opposed to technical or financial) in the decision process. It also considers the military side of economic factors such as control, information and proprietary rights, and control and management.

D. CONCLUSION

The criteria extracted in this literature review can be a tool to analyze and evaluate the decision making process in regard to the sourcing question within the DOD. The economic criteria form the basis to help the DOD determine if an outsourcing decision would make sense in a business environment. The laws and regulations provide the standards each decision maker must adhere to and must be reflected in the outcome of the decision. Some of the criterion are very detailed and are practically a ‘how to’ list. Others are very vague and leave much room for interpretation by the deciding authorities.

The following lists are an extract of the arguments discussed in the chapter. In the next chapters, these principles are applied to current examples of outsourcing in the military. Thus, the validity of the choice to have an activity performed by a private contractor can be assessed.

1. Valuable Economic Criteria for Outsourcing

- Market Conditions
- Market and Bargaining Power Estimate
- Source Dependencies
- Competition with the Firm's Own Suppliers or Buyers
- Relationship-specific Investments
- Coordination and Management Within the Stages of the Value Chain
- Taxes and Regulations
- Information and Property Rights

2. Regulatory Criteria for Outsourcing

- Only 'Commercial Activities' Can Be Outsourced
- Activities That Could Be Outsourced Must Be Competed
- Provider Performance Must Be Technically Acceptable
- The Lowest Cost Provider Must be Selected
- Estimate 'All Other Costs And Expenditures' of Outsourcing
- Examine the Potential Economic Effects of Outsourcing
- Examine the Potential Effects of Outsourcing on the Military Mission

III. CONTRACTORS ON THE BATTLEFIELD

“In all countries engaged in war, experience has sooner or later pointed out that contracts with private men of substance and understanding are necessary for the subsistence, covering, clothing, and moving of any Army.”

Robert Morris, Superintendent of Finance, 1781¹⁹

“Necessity never made a good bargain”

Benjamin Franklin, (1706 – 1790) American statesman, writer²⁰

A. INTRODUCTION

In order to conclude how adequate the government regulations for the sourcing question are, and to determine to what extent they are followed within the DOD, it is appropriate to have a closer look at some recent outsourcing decisions. One of the most controversial areas of outsourcing within the U.S. military is the replacement of military (and civilian government) personnel on the battlefield by contractor employees. Civilian contractors are providing services which place them directly in a combat zone and therefore exposure to significant dangers. Nevertheless, this has become a fast growing industry since the conflicts in the Balkans, Iraq, and the Global War on Terror (GWOT) in general. The following chapter describes the tasks and the background of the contractors working in Iraq and other conflicts in which the U.S. is involved.

B. GENERAL VIEW OF ‘CONTRACTORS ON THE BATTLEFIELD’

Commercial companies that provide military services, or support to the military, including operations in combat zones, are commonly referred to as, ‘Contractors on the Battlefield’ (COB), ‘Private Military Companies’ (PMC), or ‘Private Military Firms’ (PMF).²¹ In today’s combat operations, these civilian companies play a significant role. The rise of commercial firms in the market of global security has been attributed to

¹⁹ As quoted in the Joint Publication 4-0 - Doctrine for Logistic Support of Joint Operations (Assistant Secretary of the Army).

²⁰ As quoted in the Concise Columbia Dictionary of Quotations (57).

²¹ Despite somewhat different definitions in some of the literature, the acronym PMF is used for all these companies in this paper.

several factors. Generally, the demand for those companies can be traced to states losing the ability and the will to conduct certain military operations themselves. Singer accredits this fact to the lack of public support (especially with the broadcasting of casualties), increasing number of low intensity conflicts, and the reduced capabilities of downsized forces (8, 9). Parallel to the increasing demand of private military expertise, supply for such services has grown. Singer asserts that military downsizing at the end of the Cold War left a huge number of individuals²² with unique skills looking for new jobs (9). He claims that “[c]omplete units were cashiered, and many of the most elite units [...] simply kept their structure and formed their own private companies” (9). Additionally, the shrinking of armed forces all over the world also provided the required equipment and weapons, including tanks and fighter jets, for the emerging industry (Singer 9).

The scope of the companies’ work is widespread and can include anything from providing supplies to directly participating in combat operations. “Today's private security companies are corporate endeavors that perform logistics support, training, security, intelligence work, risk analysis, and much more. They operate in an open market, work for many employers at once, and boast of their professionalism” (Avant). Singer makes it clear that PMFs are foremost a company and as such will always be driven by profit (7). The result is a competitive market for security services and outsourcing is now an alternative available for a much wider variety of tasks. And while these activities are often regarded as ‘civilian,’ many of them are conducted with the possibility to come under fire.

Singer classifies PMFs by the type of their activities as follows:²³

- Military Provider Firms
Companies that offer services at the forefront of the battlespace and that engage in actual fighting and/or ‘Command and Control’ of field units.
- Military Consulting Firms

²² “In the 1990s, the world’s armies shrank by more than 6 million personnel” (Singer 9).

²³ Compare with Isenberg (15).

Companies that offer advisory and training services and which also provide strategic, operational and organizational analysis.

- Military Support Firms
Companies that offer rear-echelon and supplementary services (17, 18).

C. **MILITARY VIEW OF “PRIVATE WARRIORS”?**²⁴

There seems to be a common understanding that outsourcing and privatization are favorable for the military.²⁵ Yergin and Stanislaw make the case that “in response to the high cost of control and the disillusionment with its effectiveness, governments are privatizing” (13). Singer states that “[f]ewer individuals are doing the actual fighting, while massive support systems are required to upkeep the world’s most modern forces” (11). Additionally, he argues that today’s need for “high-technology warfare” results in considerably higher needs for specialized expertise which often has to come from the private sector (11). This can easily be perceived as a shift away from traditional core tasks of the military (‘the warfighter’) towards services and products readily available in a competitive market.

The U.S. military has employed civilian contractors for a long time. But in the last two decades, the dependency on PMFs and contractors has grown steadily. Isenberg states that the ratio of military to contractor personnel grew from 50:1 during the first Gulf War (1991) to 10:1 during ‘Operation Iraqi Freedom’ (OIF) (7). Practically all government agencies involved in the GWOT or in Afghanistan and Iraq employ civilian contractors. Table 1 shows the surge of contractor support for the Air and Space Expeditionary Forces (AEF) during Operation Enduring Freedom (OEF) in Afghanistan.

²⁴ Private Warriors, title of a PBS Frontline documentary about PMFs in Iraq (Frontline).

²⁵ For economic rationale for public enterprises, see Vogelsang (14).

Table 1. Contractor Support Surged During OEF
(After: Lynch et al. 58)

Type of Support	Average for OEF*	Pre-OEF Average
Direct mission support tasks	162	10
Tons of air cargo moved	1,554	400
Truckloads moved	705	200
Total tons moved	9,331	3,000

* Average calculated from data for October 2001 to January 2002

The Office of the Secretary of Defense (OSD) divides contractor support into three categories based on the type of contract:

4.1 -- Systems Support

Logistical support deployed with operational forces under prearranged contracts awarded by Service program managers or by Military Service component logistics commands. They support specific systems throughout their system's life cycle (including spare parts and maintenance), during peacetime, conflict, and war.

4.2 -- External Theater Support

Provides support for deployed operational forces working pursuant to contracts awarded under the command and procurement authority of supporting headquarters outside the theater. These may be US or third country businesses and vendors. These contracts are usually prearranged, but may be contracts awarded or modified during the mission based on the commanders' needs. Examples include the Army's Logistics Civil Augmentation Program (LOGCAP), the Air Force Civil Augmentation Program (AFCAP), the Navy's Construction Capability (CONCAP), United States Transportation Command (USTRANSCOM) provision of Civil Reserve Air Fleet (CRAF), and war reserve materiel (WRM) contracts.

4.3 -- Theater Support

Provides support to deployed operational forces pursuant to contracts arranged within the mission area of responsibility, or prearranged contracts through Host Nation (HN) and/or regional businesses and vendors. Contracting personnel deployed with the deployed force, working under the contracting authority of the theater or Joint Task Force

(JTF) contracting chief, normally award and administers these contracts. Theater support contractors provide goods, services, and minor construction, usually from the local vendor base. (Assistant Secretary of the Army, OSD Supp. ii, iii)

Figure 3 provides an overview where the U.S. currently (as of April 2003) uses contractors to support deployed forces. Table 2 shows which services contractors provide to support deployed forces.

Figure 3. Selected Countries Where Contractors Are Supporting Deployed Forces

(From: Government Accountability Office, GAO Report GAO-03-695 5)

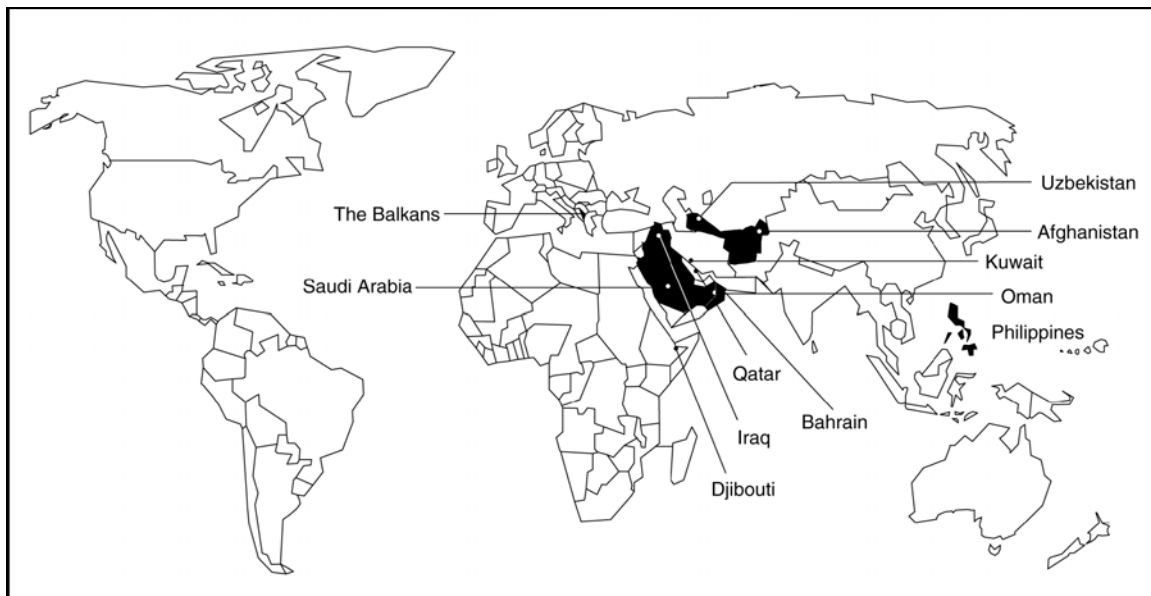


Table 2. Selected Services Provided by Contractors in Deployed Locations

(From: Government Accountability Office, GAO Report GAO-03-695 7)

Service	Balkans	Southwest Asia	Central Asia
Weapons systems support	X	X	X
Intelligence analysis	X	X	X
Linguists	X	X	X
Base operations support	X	X	X
Logistics support	X	X	
Prepositioned equipment maintenance		X	
Non-tactical communications	X	X	
Generator maintenance	X	X	X
Biological/chemical detection systems		X	X
Management and control of government property	X	X	X
C4I ²⁶	X	X	X
Continuing education	X		
Fuel and material transport	X	X	X
Security guards	X	X	
Tactical and non-tactical vehicle maintenance	X	X	
Medical service		X	
Mail service	X		

D. CONTRACTORS IN ‘OPERATION IRAQI FREEDOM’

The most recent, and probably the most extensive, example of contractor use on the battlefield by U.S. forces is Operation Iraqi Freedom (OIF) and its aftermath.

1. Development of the War

The shooting war in Iraq began officially with ‘decapitation’ strikes on 19 March 2003, intended to kill Saddam Hussein and other regime leaders. This was followed by an average of 1,500 and 2,000 air sorties per day during the early days of the campaign (Fontenot, Degen, and Thon). Iraqi attempts to sabotage oilfields initiated the ground war 24 hours earlier than intended, beginning 20 March 2003 with the 3rd Infantry Division spearheading the invasion (Fontenot, Degen, and Thon). U.S. troops reached the center of Baghdad on 9 April 2003. On 14 April, the Pentagon declared ‘major combat engagement’ to be over, while President Bush officially called it the end of major combat operations in Iraq on the USS Abraham Lincoln on 1 May 2003. Since this date, an

²⁶ Command, control, communications, computers, and intelligence

ongoing insurgency in Iraq is the focus of U.S. and coalition military forces. In parallel, efforts to rebuild Iraq are conducted by Iraqi, U.S. and international military and civilian organizations as well as Non Governmental Organizations (NGO).

The Army had divided the plan for operations in Iraq into four phases:

- Phase I. Preparation secured regional and international support, degraded the Iraqi regime's ability to resist, established the air bridge and secure lines of communications (LOCs) to the theater, sought to interdict tactical ballistic missiles (TBM) and weapons of mass destruction (WMD), and alerted, deployed, and postured American forces. In short, this phase set the conditions to neutralize Iraqi forces.
- Phase II. Shaping the Battlespace included posturing coalition forces to conduct sustained combat operations, beginning initial operations to degrade Iraqi command and control and security forces, and seizing key pieces of terrain. These actions were in addition to the ongoing diplomatic and counter-TBM/WMD operations.
- Phase III. Decisive Offensive Operations marked the beginning of conventional combat operations. It included the air campaign, preparatory ground operations, and the attack north to Baghdad. This phase culminated with securing Baghdad and removing Saddam Hussein and the Ba'athist regime from power.
- Phase IV. Post Hostilities operations encompass the transition from combat to stability operations and support operations, including humanitarian assistance and reconstruction. Interestingly, planners realized early on that as coalition forces liberated sections of Iraqi territory, operations in those sections would transition to Phase IV while Phase III combat operations continued elsewhere. This 'rolling transition' to Phase IV is the hallmark of true full-spectrum operations and is one of the defining characteristics of this campaign. The distance between forces conducting Phase III and Phase IV operations varied from meters to miles, requiring remarkable flexibility, initiative, and maturity of the leaders and soldiers. (Fontenot, Degen, and Thon)

Presently,²⁷ OIF is theoretically in Phase IV. But the difference between forces still in Phase III and those in Phase IV cannot be measured by distance. The boundaries are practically not existent and shift continuously. The ongoing insurgency results in the

²⁷ Current as of December 2005.

area of operations where contractors are employed equaling a battlefield, for the purpose of this paper. The news reports from Iraq especially make it clear that civilians are engaged in some forms of combat and the mounting death toll among the contractors is further proof.²⁸

2. Contractor Tasks in Iraq

A PBS²⁹ Frontline documentary labeled the contractors “Iraq’s 2nd largest force” due to their large numbers³⁰ (Frontline). Currently, a variety of companies perform different tasks for different customers:

- Support Contracts
Working for U.S./coalition military
- Training contracts
Working mostly for the Iraqi government
- Consulting Contracts
Working for all military or civilian agencies, Non-governmental organizations and companies in Iraq
- Security Contracts
Working for all military or civilian agencies, Non-governmental organizations and companies in Iraq
- Reconstruction of Iraq contracts
Working for the Coalition Provisional Authority (respectively, the U.S. Mission to Iraq), other U.S./coalition government agencies (e.g., Homeland security) or the Iraqi government

²⁸ A detailed and up to date (albeit only partial) listing of contractor casualties as well as other civilian and military losses (U.S. and coalition) can be found on icasualties’ website.

²⁹ PBS is the Public Broadcasting Service.

³⁰ When judged by the number of personnel, behind regular US troops, before the British forces.

Those different tasks result in a large number of contractors and workers currently being employed by many different agencies. Frontline breaks down the complete number of employees as follows:

- 50,000 support/logistics contractors.
These are civilians hired by KBR, the Halliburton subsidiary which holds the military's logistical support contract. They work as weathermen, cooks, carpenters, mechanics, etc. Most are from Third World countries and the majority is Filipinos.
- 20,000 non-Iraqi security contractors.
Of these, 5-6,000 are British, American, South African, Russian or European; another 12,000 are from Third World countries, such as Fiji, Colombia, Sri Lanka, and India.
- 15,000 Iraqi security contractors.
Most of these were hired mainly by the British security firm Erinys to guard Iraq's oil infrastructure.
- 40-70,000 reconstruction contractors.
Hired to rebuild Iraq. Some are Iraqis, but they're mostly from the U.S. and dozens of other countries and employed by companies such as General Electric, Bechtel, Parsons, KBR, Fluor and Perini.
(Frontline)

With regard to the U.S. military as employer, the Council on Foreign Relations (CFR) lists on its website the kind of tasks which contractors are currently performing in Iraq:

- guarding officials, military installations, and supply convoys;
- training local troops and police forces;
- providing interrogators, translators, and transcribers;
- maintaining and repairing vehicles and aircraft, including the guidance and surveillance systems on tanks and helicopters;
- running logistics operations and supervising supply lines;
- driving supply trucks that carry fuel and food;
- providing warehousing and storage facilities;
- setting up Internet access and maintaining computer systems;
- preparing meals for the roughly 135,000 U.S. soldiers;
- cleaning military facilities, including Army bases and offices;
- washing clothes;
- and building housing. (Council on Foreign Relations)

The majority of the contractor personnel performing tasks that have been traditionally military are employed in the logistic/support and security segments. GAO reports that “the DOD estimates that there are at least 60 private international security providers working in Iraq with perhaps as many as 25,000 employees”³¹ (Government Accountability Office, [GAO-05-737](#) 8). Isenberg has included a short description of most of the security companies working in Iraq.³² According to his research, the majority of the PMF provide security for assets and/or personnel (see the first bullet in the above listing). They do that for other firms or civilian government agencies working in Iraq, as well as for U.S. and coalition troops and the new Iraqi armed forces. Those services can range from consulting to close protection of personnel. It encompasses the guarding of facilities (e.g., oil fields or warehouses) and convoys. The firms also provide training to nearly every kind of player (private or governmental/military) in Iraq. Companies also provide airborne surveillance security for U.S. Air Force launch facilities, security databases and intelligence information (including collection and analysis), and prisoner and prison facilities handling (including the now infamous interrogations in Abu Ghraib). Although many of these companies in Iraq and other operations conducted their business in combat situations, none of the category that Isenberg calls ‘combatant’ (Singer: ‘military provider’) are currently officially operating in Iraq (Isenberg 15).

3. Contractor and Combat

None of the contractors in Iraq were explicitly hired to conduct (offensive) combat operations. Most of them are performing tasks that are required of many companies that are not in a combat zone. Guard duties, truck driving, maintenance and even interrogations are not combat duties per se. In Iraq, however, practically at no time has an established frontline existed. Consequently, a relatively peaceful ‘hinterland’ is missing. This results in nearly all contractor personnel, notwithstanding how mundane

³¹ This includes all companies in Iraq, including those hired by civilian US government agencies.

³² Compare with Isenberg in [A Fistful of Contractors](#) (Appendix 2).

their activities might be, performing under a constant threat of getting attacked.³³ As a result, civilians might be armed and engage hostile forces. Also, contractors get killed due to hostile actions. The first American killed in combat in Afghanistan was a civilian CIA contractor (Isenberg 20).

The other form in which contractors might be participating in combat is through the tasks which they are performing. A contractor maintaining Global Hawk unmanned aerial vehicles (UAV) could be considered to be in combat. Some contractors might even be operating equipment for the armed forces.

It needs to be stressed that none of the applicable regulations or laws regard 'combat' necessarily as an 'inherently governmental' function. For the purpose of this paper the important distinction is therefore not if a contractor is in combat or not, but if the activity constitutes the performance of an inherently governmental function. This will be discussed in Chapter IV.

E. CONCLUSION

Contractor support for military operations has significantly grown over the last two decades. It has reached a state where it has become vital to the DOD, particularly for the operations in Iraq. The performed tasks have expanded from traditional support to vital activities without which some weapon systems could not be operated anymore by the military. Civilian contractors also carry out more security related duties which are reflected in the growing number of Private Military Firms operating in Iraq. The increase in number and variety of tasks, in combination with the situation of a non-linear battlefield in Iraq, results in many contractors operating de facto on the battlefield and in combat situations in a traditional military environment.

³³ The same problem also affects the military. 'Traditional' support troops (e.g., Reserve or National Guard), not equipped with the latest technology and often not well trained for combat, are now suddenly performing their duties constantly in a war zone. The most famous example is probably the initial lack of armored 'Humvees' for these troops.

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IV. APPLICABILITY OF OUTSOURCING CRITERIA TO THE SITUATION IN IRAQ

“I’d like to see the government get out of war altogether and leave the whole feud to private industry.”

Joseph Heller (1923 - 1999) American novelist³⁴

A. INTRODUCTION

Chapter II described the economic and regulative principles that govern the outsourcing decision. Chapter III portrayed contractors on the battlefield as an example of outsourcing. This chapter examines the government rationale for the use of contractors in Iraq. It then analyzes, using the points extracted in Chapter II, if the decision was justified economically and if the decision making process followed the government regulations. It also discusses additional consequences that need to be considered when faced with a sourcing decision. Where applicable, the chapter will also raise ‘Questions to Consider.’ These questions should be taken into account by the decision makers as they regard issues that could have a negative effect, even if a principle is otherwise valid.

B. DISCUSSION OF ECONOMIC CRITERIA WITH REGARD TO MILITARY OUTSOURCING

Business has a clear objective in its operations. “The company exists to make money” is a big revelation that Goldratt has his hero discover in his bestseller The Goal (Goldratt 40). Consequently, every decision a company makes is aimed to secure the existence of the company and to assure that it will make a profit in the end.

Administrations, on the other side, have different priorities. Gordon comments that governments don’t make money, but spend it (Marketplace). One would hope that the DOD is actually neither motivated by making money nor by spending it. Its goals are mission driven. According to Meehan, “military requirements are to be an outgrowth of defense strategy built to satisfy national military objectives” (29). McCaffery and Jones

³⁴ As quoted in the Concise Columbia Dictionary of Quotations (663).

stress that the defense budget is in important ways different from non-defense budgets by being an instrument of foreign policy and should correspond with the threat to our interests posed by foreign nations (3). There was a common understanding during the Cold War that every dime spent by the Department of Defense (DOD) was justified by the dangers lurking outside the borders. The military needed and deserved the best equipment, the best everything money could buy to ensure the safety of the nation. This philosophy saw its high water mark during the Reagan administration. The United States (U.S.) outspent the Soviet defense budget and thereby contributed significantly to the fall of the 'Evil Empire.'

These statements make it obvious that the main focus of military spending is guided by the policies and objectives of the government. The DOD will determine what it needs to achieve these objectives and how much money is necessary to do so based on an analysis of requirements and existing military capabilities. But from its first days as an independent nation, the United States has kept the right to decide on what to spend money separate from those who will spend the money. As a result, the DOD will only be able to spend what Congress appropriates for its purposes. These funds are normally less than what the military had asked for and never limitless. Consequently, even when not being in the business of making money, economic principles do apply to the military. Heberling and Kinsella point out that today's focus tends more and more towards affordability. The DOD needs to strategize if they want to get the often quoted, 'biggest bang for the buck.' Today the DOD pays close attention to 'best business practices' in order to improve their operations. "The emphasis both within and outside the Defense Department is to use more commercial products and commercial practices in meeting military requirements" (Heberling and Kinsella). Consequently, it is appropriate to examine the applicability of some of the general economic principles that govern commercial practices to outsourced contracts in Iraq and similar operations.

1. Valuable Economic Criteria for Outsourcing

a. Market Conditions

This criterion supports some of the outsourcing of services required in Iraq, but not all.

Some of the PMF's operating in Iraq already existed in the 1960s or '80s (e.g., AMK Group or ArmorGroup). But many of the smaller companies got started in the 1990s or early 2000s when the need for such companies increased due to operations in the Balkans (e.g., Blackwater, AEGIS, ERINYS).³⁵ One could consequently argue that due to the small number of companies, the market for PMFs was hardly competitive at the time when the U.S. decided to outsource security in the Balkans and the Middle East. Isenberg quotes Surowiecki in requiring that the competition among suppliers must be genuine (17). Considering the length of the conflict so far and the variety of firms employed in Iraq, it appears that a competitive market for PMFs is now developing. Also, the market for the development and support of advanced weapon systems, after many decades of consolidation in the defense industry, is rather limited.

Brickley, Smith, and Zimmermann conclude that when competitive outside markets are available to purchase goods and services, they should be used (519). Avant, on the other hand, argues that the government itself often curtails competition. She provides the example of Kellogg, Brown & Root, who "won a no-bid contract to rebuild Iraqi oil fields in 2003 because the Pentagon determined it was the only company with the size and security clearances to do the job." This statement seems to indicate that the Army did not believe that a competitive market existed for some capabilities. The market conditions would, consequently, not necessarily support the decision to outsource the activity.

³⁵ Data about the different firms was obtained from companies' websites. Those websites were linked from Frontline.

Questions to consider:

- Does the DOD consider existing competition in the market place when requesting a proposal and negotiating the contract?

b. Market and Bargaining Power Estimate

The criterion generally does not support outsourcing of activities for OIF, mostly due to the military's self declared lack of urgently required capabilities.

The U.S. government, especially the military, is the biggest source of contracts in the U.S. The contracts awarded for the war in Iraq are worth billions of U.S. dollars. Consequently, one could argue that the DOD's absolute market or bargaining power in the vertical chain should be high and that outsourcing would be the right decision.

But as pointed out in Chapter II, it is all about the relative power. When already engaged in combat or about to do so, the military's bargaining power is not at its highest. Contract negotiations conducted when it is apparent that the government cannot fulfill its tasks without the support of the PMFs obviously put the bargaining power on the side of the contractors. When the DOD justified the push for outsourcing with its own lacking capabilities and the inability to provide the required support fast enough with military means, it undermined its own bargaining position in some way. The higher costs that can result from these actions need to be recognized in the analysis leading to the sourcing decision.

One tool used by the Army, that can help avoid this problem, is the LOGCAP³⁶ contract. These contracts are awarded in advance (when the bargaining power of the government should be intact) and remain dormant until they are needed, in which they can be executed fast and without requiring any new negotiations (when the government is under pressure). LOGCAP contracts are normally meant for the early

³⁶ LOGCAP stands for the 'Logistics Civilian Augmentation Program' of the U.S. Army. The other branches have similar contracting tools available.

phases of a deployment (up to 180 days) but in Iraq are currently also used during the sustainment phase of the operation.

Questions to consider:

- Can the DOD influence the bargaining power to its advantage via the timing of negotiations?

c. Source Dependencies

For obvious reasons, the risk and threat from being dependant on a source is much higher for a military force in combat than for nearly any other firm. This criterion only partly supports the outsourcing decision for OIF, as it increases the risk of source failure for at least some of the capabilities.

As with any other risk, failure of a source is defined by the likelihood of its occurrence and its impact on the process. One of the most important factors in determining the chance of being without a supplier (or buyer) is the availability of alternatives. Many of the products and services outsourced in OIF come from a competitive market, e.g., fuel, food services, transportation, etc., and could be regarded as a low risk. Other activities are more specialized, such as the security provided by PMFs or maintenance of high-tech weapon systems, and consequently bear a higher risk. The risk for all activities is, however, aggravated by the fact that they are performed on a battlefield. In opposition to military personnel, the contracted firm or its employees can decide to terminate the contract at any time. Less severe punishments for contractors not performing their assignment, compared to military personnel refusing an order or being AWOL³⁷, also increase the possibility for workers leaving their job. Lynch et al. state that the Army experienced poor living conditions because contracted workers did not show up (58). There have been examples in Iraq where contractor personnel has quit after being confronted with hostilities or the violent death of coworkers. While the incidents normally concern activities that are not very specialized, such as truck driving, they still can have a decisive impact on operations. A breach of contract will take a long

³⁷ Absent Without Leave

time to sort out, especially when the court system is involved. It might be especially difficult with non-U.S. contractors. Also, personnel might rather bear the consequences of breaking a contract than the prospect of death in a combat zone.

The risk contained in the sourcing decision is twofold. The more crucial risk is the danger to the success of the operation and to the life and health of those engaged in it if a source fails to perform as required. The second risk is the costs incurred by the military to ensure that a substitute or back-up is available. The main problem of dependency for the forces in Iraq is the timeframe in which a source can be replaced without endangering the ongoing operations. In order to minimize the first risk, the DOD is most likely to increase the second one in the form of higher direct and indirect costs of the outsourced contract.

Questions to consider:

- How can the source dependency risk be mitigated?
- Are the direct and indirect costs of mitigating the risk included in the cost analysis?

d. Competition with the Firm's Own Supplier or Buyers

This economic criterion does not necessarily apply to all companies in Iraq, but might affect the relationship between the DOD and some industries in the long run.

By being traditionally very vertically integrated, the military is competing with its suppliers. Industries might be adversely affected by this competition, some more than others. If security services used to be provided solely by the military, the supply base for such services would have been weakened, potentially unable to achieve the quality standards required by the DOD. Other services, such as delivering supplies or running a canteen, might not have been affected at all by the military performing the same tasks. Conversely, outsourcing certain tasks, even while retaining some capabilities

can help the government by strengthening the supplier base, thereby providing a competitive market for when the military is in need of additional services.

If the services have already been outsourced, the threat of future integration into this sector can increase the governments' bargaining power. Major companies or industries might try to exercise political pressure, if the DOD decides to integrate or not to outsource in order to counter the effects described above.

e. Relationship-Specific Investments

From the DOD's perspective, the high investments make it hard to decide if this criterion supports the decision for outsourcing.

Working with the military, especially in a combat zone, could result in high costs for the contractor. Even performing ordinary tasks such as providing a canteen or trucking supplies can become expensive in Iraq. The execution happens far away from existing infrastructure. Security requires thorough screening of all employees and protection of facilities and workers. Lynch et al. point out that insurance premiums in a war zone are extremely costly (58). Assimilating commercial activities into the military organization carries a high cost of adapting the equipment of those companies to military requirements or standards. In addition, it raises the question of confidentiality of information provided to contractors by the military (s. paragraph 'Information and Proprietary Rights').

The costs of a relationship specific investment have two dimensions. On one side is the total amount that will be invested. On the other side is the relationship specificity; the degree to which the investment is only useful for the relationship in question. The following examples demonstrate the difference. Material investments by a company that will provide food services in Iraq can be low. It needs to buy the equipment, set up a supply system and hire the necessary people to run the facility. These assets can easily be used for similar services outside the military. Their specificity is consequently also low. A firm contracted to provide maintenance for artillery pieces might not require high investments. Tools and supplies are often provided by the military. The personnel needs to be compensated, but training might be paid for by the military if the firm hired former soldiers. As the market for this kind of service is very

small outside the military, the relationship specific investment dimension would be high. A contractor operating major weapon systems for the military in Iraq faces not only high investments to do so, but also a very high relationship specificity. Figure 3 illustrates these arguments.

The investments and the specificity might also change over time. Investments into training are currently low for security companies hiring former Special Forces to fulfill their contracts in Iraq. Avant says that “[s]ome analysts argue that contractors are ultimately cheaper because they allow the military to avoid the expense of recruiting, training, and deploying personnel. But most contractors are recruited and trained by governments at some point in their careers.” As a potential result of the efficiency and effectiveness of outsourcing security services, the military might decide to no longer have any Special Forces of its own. The investments by these security companies, and consequently the prices they charge, would increase, as the firms have to pay for the training themselves. If the government intends to keep Special Forces, they might have to pay higher salaries to prevent the soldiers from leaving the Armed Forces as soon after their training as possible.

Any contractor that makes these investments has to be concerned with recouping the costs. Considering the alleged short time of operations in Iraq, the firm has to do so fast, as the services or equipments might not be useful after the end of the war. But several factors favor the firm. The cost of actual labor can be comparatively cheap, depending on whom the company hires. For employees of security firms, the pay can vary from U.S. \$ 30,000 a month for a former Green Beret to just U.S. \$ 250 for a Kurdish Pesh Merga (Council on Foreign Relations). Many other companies employ for the majority of jobs local or ‘imported’ workforces who are not paid to American standards. Even some of the required equipment is cheap. Security firms can buy surplus military gear, especially small arms, etc. According to Smith’s theorem, an individual must make up-front investments of time and/or money to develop special skills (Besanko, Dranove, and Shanley 119). With the dramatically increased demand for qualified civilian security personnel, PMFs aggressively recruit from government agencies. Many of the security staff in Iraq are former military or law enforcement

personnel.³⁸ Finally, the integration of support activities into an operational network is only at its beginning stages and not necessarily enforced, thus sparing the firm some investments. Besanko, Dranove, and Shanley conclude that the majority of the activities performed by the PMFs do not require great investments (119).

Buzzell states that the operating cost savings have to be substantial to justify vertical integration (94). Without published, detailed, direct and indirect cost resulting from outsourcing activities, it cannot be determined if all investments were considered when making the decision and if, indeed, outsourcing was the more efficient way.

Questions to consider:

- Who bears the financial risk of investments resulting from the sourcing decision?
- What is the impact on military operations if investments are not/not fully made?

³⁸ Compare with Appendix II.

Figure 4. The Two Dimensions of Relationship Specific Investment

		Relationship Specificity	
		High	Low
Investment	High	Operating Major Weapon System	
	Low	Artillery Maintenance	Providing Food Service

f. Coordination and Management within the Stages of the Value Chain

This criterion does not support the outsourcing decision.

The success of the Armed Forces in Iraq in managing contracts appears to be mixed, mainly due to the inadequate number of personnel assigned to the management of contracts and insufficient training (Government Accountability Office, [GAO-04-854](#) 42 - 45). Campbell explains that the relationship between contractor and the government is governed by the Terms and Conditions of their contract (5). He emphasizes that only a Contracting officer (KO) can direct a contractor and that consequently the “[c]ommander must ‘manage’ contractor personnel through the contracting process” (5). It also could increase bureaucracy when military commanders and contractors have to coordinate the actions in the theater, especially when both sides have no experience in cooperation on this level. Everyone familiar with the normal proceedings of this process will recognize that it is often not convenient on a battlefield. Military commanders might also not have the education to deal with contractors under battle stress. Isenberg claims that in 2003 then Army Secretary Thomas E. White raised the question whether it is within the

capability of the Army to effectively manage the “force of private contractors” (20). Failure in management can lead to casualties and additional cost. According to Grant, “[o]ne of the major sources of administrative costs of vertically related business arise from coordinating businesses that, in strategic terms, are very different” (322). Brickley, Smith, and Zimmermann point out that the necessity for better coordination between activities could justify vertical integration (524).

The military has begun to counter these problems by deploying contracting officers to deployment areas to shorten the reaction times. The GAO investigated the military’s management capabilities at the example of Logistic Support Contracts in its report GAO-04-854. The report notes that the customer (the Armed Forces) often did not provide the necessary oversight to ensure the economical and efficient execution of the contract or to control the contract’s cost (3). The report also states that the Army did not always follow its own regulations when planning for OIF with regard to including contractors in the planning process (14). Other Army organizations and the other branches seemed to be more successful in their management efforts. But the Air Force, for example, at the time of the report could not account for equipment that was purchased worth U.S \$ 2 million (Government Accountability Office, GAO-04-854 24).

The same report also found that the Armed Forces performed less than optimal in defining their requirements. In one extreme example, the requirements were overstated by 97%, which does not reflect good management of all stages of the value chain (Government Accountability Office, GAO-04-854 36).

Other factors also affect the coordination efforts. As mentioned in the paragraph above, U.S. military doctrine stresses the importance of integration of all players on the battlefield into one common network. The Lexington Institute points out that “timely, accurate and comprehensive battlespace situational awareness, [...] is effective only where intelligence, operational and logistical capabilities are part of a cohesive, integrated network” (15). With civilian firms replacing military units this necessity does not go away, but its fulfillment becomes more complicated. Besides the technical obligations discussed earlier, the main emphasis for the deployed military is

contract management. It normally either involves the execution of existing contracts or the award of new contracts in support of the operation. New contracts can be regular contracts negotiated and signed in the U.S., or so called contingency contracts, which in their majority are awarded in the theater of operations. Contracts are the exclusive responsibility of a contracting officer. He is the point of contact between the customers of the contract and the company performing the contract.

A contract award must be fast enough to satisfy the military requirement in time. After the award, a military commander can only require a contractor to carry out tasks that are clearly defined and covered by the contract. The commander can also not directly enforce provisions within the contract as well as not settle disputes. The military channels must be close and fast enough to allow fast turn around times whenever problems with a contract occur. It would have an especially negative impact if a contract dispute could not be solved in theater, but would result in legal actions. The success depends significantly on the experience of the contract officers and the government as a whole in managing outsourced activities. Adding to the coordination workload of the military commander is the requirement of contingency plans for failed contractor support. DOD Instruction 3020.37 requires military components working with contractors which perform “essential services” to develop and implement plans to ensure the continuation of those services in a crisis situation (Department of Defense 2).

The performance under a contract is often subject to litigation in the U.S. It is likely that conflicts also will and did arise over the interpretation of contracts outside the U.S. or on a battlefield. While we can safely assume that most contractors will try everything within their capabilities to support troops in combat, the local commander will have to deal with these disputes. Zamparelli argues that “the component commander cannot compel contractors to perform, even under contract, if it would force them to go into harm’s way” (13).³⁹ Fredland, on the other side, argues that “[t]he firm’s power is limited here by the importance of its reputation” (211).

³⁹ Compare with assistant Secretary of the Army JP-04, Chapter V, Article 15 - Discipline.

Questions to consider:

- Does the local military commander have the means to utilize contracts in a way that supports his operations in a timely manner?

g. Taxes and Regulations

The criterion supports outsourcing in Iraq, especially when taking self-imposed regulations in order to support new military concepts ('lean') and public perception of the war into account.

Grant concentrates on transaction costs in the form of taxes. But he also explains that "[t]ransactions costs may take the form of [...] regulations" and that the degree of vertical integration can appropriately be used to cheat on quotas (321). One significant obstacle to the deployment of military forces could be regulations that limit the number of uniformed personnel/service members allowed to enter an area of operations. Internal or external regulations might put limitations on the number of uniformed personnel the DOD can deploy. Internally, Congress can constrain the President's ability to conduct operations by only allowing a certain number of members of the Armed Forces to be deployed. Congress accomplishes its controlling power by requiring the executive to seek a new approval if it wants to go beyond the original numbers. This would result in a new discussion and another vote. Externally, international laws, UN regulations, or host nation⁴⁰ laws and concerns may try to put a ceiling on the number of foreign troops entering a country.

The need to overcome such restrictions was one of the reasons given by Joint Publication 4-0 - Doctrine for Logistic Support of Joint Operations⁴¹ (Assistant Secretary of the Army, JP4-0 V-1) and report GAO-03-695 on why the government chose to use contractors in the Balkans and partly in Afghanistan and Iraq.

⁴⁰ 'Host nation' describes a country in which US or other foreign troops are deployed and operating. The term 'host' does normally, but must not necessarily indicate that the troops are invited by this nation.

⁴¹ This publication is normally referred to as JP 4-0.

In Bosnia in 1995, for example, the Army was restrained by a presidential order not to call up more than 4,300 reservists. It consequently turned to contractors (Brown & Root and others) to make up for these restrictions (Bianco et al.). This enables the Army, according to Army Regulation 700-137, to adequately support current or programmed forces (Army Publications Directorate, AR 700-137 1). JP 0-4 and GAO-03-695 both recognize that civilian contractors are mostly not counted as part of the contingent of the Armed Forces (Government Accountability Office, GAO-03-695 2).

Singer claims that:

Much of the push behind the use of [...] firms by the U.S. military in recent contingency operations resulted from two factors: congressional limits on troop numbers and the reluctance of the Clinton administration to deal with the potential cost of calling up the National Guard and the Reserves, who would have been other wise required.

(Singer 37)

Limiting factors in Iraq were of a more political nature, such as the number of reserves and National Guard units that the DOD was willing to call to active duty. With the continuation of the war, there seems to also be a public notion to reduce the numbers of soldiers in Iraq. Nevertheless, the argument stated by the government is, in principle, valid from an economic standpoint and the Army realizes the value of augmenting uniformed forces with civilian contractors because “[u]tilization of civilian contractors in a theater of operation will release military units for other missions to fill shortfalls” (Army Publications Directorate, AR 700-137 1). By contracting out functions that do not necessarily require uniformed personnel, the government is in a position to deploy more combat troops. In the words of JP 4-0, contractors act as force multipliers and thereby enhance the theater commanders’ ability to fight (Assistant Secretary of the Army, JP 4-0 V-1). It permits the already deployed forces to concentrate on fighting tasks rather than support operations.

If the argument is used to avoid regulations, this can easily be perceived (by those who issued the regulations and by the public) as ‘cheating.’ When applying the argument, the government therefore also has to consider the political transaction costs of appearing to be dishonest.

Questions to consider:

- Can avoiding regulations be interpreted as cheating and what effect does this have on achieving the government's policies?

h. Information and Property Rights

There is no evidence so far that secure information or property rights have been disclosed by the use of contractors in Iraq. The fact that it has not happened yet, does, of course, not exclude the possibility that it might happen in the future. This criterion does not rule out the use of contractors in Iraq, but it requires the decision makers to be cautious of the potential dangers of disclosure.

The DOD has some interest in commercial data not being distributed by contractors. Moore judges the barriers to outsourcing in the DOD to have been the most intrusive⁴² (66). According to him, Congress justified the legal impediments by ruling that private firms could pose a threat to 'national security interest' (66). Business information that is illegally acquired by companies might be used in future negotiations to give these companies an advantage. But the information that needs to be closely protected is technical or operational details of weapon systems and details of military operations. Principally, it is a similar argument as in the commercial world. The consequences can be much more severe if the information is disclosed to unauthorized elements.

The required coordination between military and civilian contractors cannot be achieved without distribution of that data. Especially security companies will learn a lot about the safety precautions in Iraq. Logistics companies are familiar with ongoing operations which they are supporting. This generates the danger of other parties acquiring this information through the companies. That can happen either with the firm's, or some employee's, knowledge or without. Attacks on information technology pose a special risk.

⁴² When compared to other agencies.

The military must also be absolutely sure that the contractor does not switch its allegiance during the conflict.⁴³ Not only would this leave the U.S. military missing important capabilities, it would provide these capabilities to the opposing side. It also can provide important operational, logistic, or technical information about the original side to the opponent.⁴⁴ Fredland generalizes that “The contractor presumably has no loyalty to the state and its leadership” (211). This statement seems to be unlikely when looking at the U.S. Army and major U.S. companies, such as Halliburton. As discussed, many companies employed in Iraq are foreign. Additionally, U.S. companies often only act as a prime contractor, subcontracting portions of the contract to local vendors and workers. Considering the current insurgency in the country, the loyalty of those locals is much harder to determine and increases the “hazard of probity” (Fredland 211).

Questions to consider:

- Are processes in place that determine the exact ‘need to know’ for commercial companies?
- Are processes available that help the government to evaluate the security in commercial companies?

2. Additional Economic Arguments Given by the Government

The following, seemingly economically rooted, reasons are given in Joint Publication 4-0 and Government Accountability Office (GAO) reports for the decision to outsource contractor support for the U.S. Army for operations from Bosnia to OIF:

⁴³ Or do so after the conflict.

⁴⁴ Compare paragraph ‘8. Information and Property Rights’ in this chapter.

a. Contractors Provide Capabilities that the Army Does Not Have

This argument is a questionable one as defined in Chapter II and should not be used alone to justify a long-term sourcing decision.

JP 4-0 and GAO-03-695 both acknowledge that the military might be lacking certain capabilities. For one, it could be a competence that the military never possessed. This can be due to the fact that the capability is new or included in a weapon system that has not yet been operationally fielded. Isenberg names the Army's 4th Infantry Division (4th ID) as an example. Their digital command-and-control system was still under development and therefore supported by 60 contract employees in Iraq in 2003 (21). The author also mentions the many commercial-off-the-shelf (COTS) products which are utilized in all branches of the Armed Forces. He explains that the services often do not train military personnel in the maintenance of COTS systems. Instead those services are acquired from contractors (21). The OSD Deskbook Supplement also mentions the growing reliance on the latest technology. (Assistant Secretary of the Army, OSD Supp. 1) It could as well be that the Army has a capability but just not as much as is required at a certain point in time. This can often be attributed to the increasing technical complexity of systems and the according skills required to operate or to maintain them. GAO-03-695 states that the military does not have a sufficient amount of some highly technical or specialized skills to provide for massive operations (Government Accountability Office 2). Additionally, the Army might want to retain some of their capabilities for a potential parallel contingency, i.e., "to leverage assets" (Assistant Secretary of the Army, JP 4-0 V-1). Campbell asserts one of the significant benefits of utilizing contractor capabilities is to provide capabilities that are currently not available in the Army (3).

The military might have indeed lacked some of the capabilities to conduct Operation Iraqi Freedom. It might also have been justified to fill a capability gap through contracting as a short-term solution. For the long-term, however, the lacking capabilities should have been the rationale to initiate a thorough sourcing decision process, not the justification for a particular outcome of that process.

b. Contractors are More Efficient

This argument is a questionable one as defined in Chapter II and should not be used to justify a sourcing decision.

As described earlier, the government, and especially the DOD since the end of the Cold War, is under constant pressure to spend less money. Singer suggests that the privatization movement “reflects the current assumption that the private sector is both more efficient and more effective” (13). A GAO report, however, states that neither DOD nor any of the other involved government agencies have complete data on the costs associated with the use of contractors (Government Accountability Office, [GAO-05-737](#) 4). Even on the contracting level, costing information was not readily available (Government Accountability Office, [GAO-05-737](#) 4).

From the available data, it cannot be concluded that the reasons stated by the government as to why it is beneficial to outsource activities on the battlefield are valid or partially valid. Investigating if the outsourced activities are indeed more effective than a government office is also beyond the scope of this paper. But effective execution of an activity is always a prerequisite for any sourcing decision, and never the justification in itself.

c. Contractors are More Effective

Effectiveness alone is another questionable argument. When considering civilian contractors more ‘effective,’ the DOD mostly refers to two assumptions. One, that it is easier and faster for the military to outsource an activity required in case of a deployment than to develop the same capability within the Armed Forces. And two, that for some capabilities that experience frequent changes, contractors are better suited as they are more flexible in adapting to these changes, as well as to new technologies.

During OIF, at times the DOD utilized new equipment which sometimes was still in its development phase. Among the examples is the new Unmanned Aerial Vehicles (UAV) or devices to counter Improvised Explosive Devices (IED). The operation or the maintenance of these systems constitutes new skills for the military. “The continued introduction of these high-tech systems into our arsenal has meant more reliance on contracted personnel to provide unique field service representation to

maintain these highly complicated and dynamic systems” (McBride 2). The training of military personnel would take time and money. Using contractors allowed deployment of the system faster and before the design was stable enough to justify a lengthy process of military training for it.

As for some of the other government rationales, better effectiveness is a prerequisite to choosing a provider. But the decision makers also have to investigate why it is that one source is more effective than the other. Consequently, they must determine if anything can be done to increase effectiveness and the most beneficial way to do so.

C. DISCUSSION OF REGULATORY CRITERIA FOR OUTSOURCING

1. Only ‘Commercial Activities’ Can Be Outsourced

As there is no clear definition of ‘inherently governmental,’ outsourced activities in Iraq appear to be commercial in the sense of the regulations.

There seems to be a common understanding that the government should only conduct activities that are governmental and not commercial. The conception of what actually is governmental is less clear. There are several approaches to determine which activities the government should retain. Some argue that activities that are more effectively performed by the market place should be outsourced. Yergin and Stanislaw refer back to Al Gore’s ‘Reinventing Government’ initiative, recommending “spinning off functions to the private sector that are better accomplished there” (358). Gordon also believes that to ensure the success of a job it should be privatized if it can be done effectively (Marketplace). Others believe that everything that can be done by a commercial activity should be done commercially. In 1988, the President’s Commission on Privatization suggested the federal government should not enter competition with the private sector if the required goods or services are commercially available (Blue Ribbon Commission Appendix, xviii). Grimsey and Lewis quote Seldon in saying that “the larger part of the public sector is a political artifact, not an economic necessity or a public preference” (94). Arguing along the same line but reversing the statement, Gordon advocates that “governments should do what only governments can do” (Marketplace). Those activities that only the government can do are known as ‘inherently governmental.’ In the commercial world this principle is expressed as ‘core competencies’ or

“specialized expertise” as understood by Prahalad and Hamel.⁴⁵ For the United States government, the Office of Federal Procurement Policy has issued a policy letter in 1992 in which it defined those functions.⁴⁶ A-76 uses the same definitions.⁴⁷

Military operations are clearly at the top of the list when one thinks about ‘inherently governmental.’ “Establishing and maintaining a system of law and order has traditionally been seen as a fundamental role of government” state Grimsey and Lewis (94). Singer makes clear that a “general assumption about warfare is that it is engaged by public militaries” (5). Not everything that has to do with warfare is necessarily inherently governmental. Policy Letter 92-1 reduces the governmental functions of the military to “[t]he commands of military forces, especially the leadership of military personnel who are members of the combat, combat support or combat service support role” (Office of Federal Procurement Policy Appendix A). It does not further define which functions in the military are to be retained by military personnel. Secretary of Defense Donald Rumsfeld leaves no doubt that there is much to outsource for the military. He also appears to refer to the actual ‘fighting’ as what he wants uniformed personnel to do. At a town hall meeting in Iraq in July 2005, he claimed that many jobs in the military can be performed by civilians rather than uniformed personnel. He said:

[I]t’s estimated by people who do these calculations, that we have something like 300,000 men and women in uniform today currently doing things that civilians can do. So what we’ve done is over time allow uniformed personnel to slide into tasks and activities that are interesting and can be done by military people but need not be done by military people. And we’ve been in the process of moving some of the military people out of those types of activities and into activities that more closely approximate the kinds of things an individual who volunteers to serve in the military expected to do when they stuck up their hand and said send me. (DOD News)

⁴⁵ See also ‘Definitions’ in Chapter I.

⁴⁶ See also ‘Definitions’ in Chapter I.

⁴⁷ There is one exception. A-76 omits the function of commissioning, appointing or controlling officers of employees of the U.S. as listed in the policy letter under (e).

Not only are there obviously many commercial activities still performed by the military, many activities formerly considered to be ‘military’ are now performed by companies. The distinction between the two is constantly shifting and becoming blurred. The United Kingdom’s (U.K.) Royal Navy, for example, has just leased a warship for five years to conduct offshore patrolling activities in the Falkland Islands. While the ship is operated and manned by the Royal Navy, the company, VT Group, will own the ship and provide all the support services (DefenseNews 18). Avant supports this argument by explaining that “[a]lthough U.S. Defense Secretary Donald Rumsfeld said the Pentagon would outsource all but core military tasks, these tasks are changing, and military contractors perform many of them.”

But where to distinguish exactly between the different functions is still not defined as a general applicable rule. Policy Letter 92-1 acknowledges this problem and the difficulty to provide an exact definition:

The difficulty is in determining which of these services that fall between these extremes may be acquired by contract. Agencies have occasionally relied on contractors to perform certain functions in such a way as to raise questions about whether Government policy is being created by private persons. Also, from time to time questions have arisen regarding the extent to which de facto control over contract performance has been transferred to contractors. This policy letter provides an illustrative list of functions, that are, as a matter of policy, inherently governmental (see Appendix A), and articulates the practical and policy considerations that underlie such determinations (see [[section]] 7).

As stated in [[section]] 9, however, this policy letter does not purport to specify which functions are, as a legal matter, inherently governmental, or to define the factors used in making such legal determination. Thus, the fact that a function is listed in Appendix A, or a factor is set forth in [[section]] 7(b), does not necessarily mean that the function is inherently governmental as a legal matter or that the factor would be relevant in making the legal determination.

(Policy Letter 92-1)

Following the general policy in the letter, the line is drawn between determining and controlling policies, laws and their execution (governmental), and merely performing

that execution (commercial). Despite the vast room for interpretation that this leaves, the activities of contractors in Iraq appear to be commercial.⁴⁸

Questions to consider:

- Who determines the factors that decide what inherently governmental is?

2. Activities That Could Be Outsourced Must Be Competed

This criterion only partly supports the awards of contracts for OIF.

Many of these laws have their origin in former abuses by the DOD and the lawmakers wish, and privilege, to exercise the ‘power of the purse.’ But, implicit in this process is also the general understanding of a government always having to be ‘fair’ in its proceedings. Heberling and Kinsella believe that to be counter-productive:

This outgrowth of fairness permits a stream of protests that frequently result in a costly paralysis of the procurement system. The preoccupation with competitive fairness hinders the use of innovative long-term supplier partnering arrangements. In the commercial sector, the prevailing attitude is: *Who said business was fair?* A private firm can choose with whom it wants to do business, to what degree, and for how long. Consequently, the private sector rarely has to deal with protests as the DOD does. A commercial supplier knows better than to protest. To do so will result in their being "blacklisted" throughout the industry.

(Heberling and Kinsella)

The process described in A-76 and related implementation guides should guarantee that each outsourced activity is competed before awarded as a contract. But A-76 is based on the idea that the government identifies the existing commercial activities and then competes them between contractors and the government agency. As many of

⁴⁸ This statement is based on the intentions of the contracts. There is an obvious impact by actions of contractors (covered by the contract or not) on the policies of the government. For example: contractor employees firing, apparently at will, on civilian cars, hitting them and causing accidents, are perhaps likely to impact the government’s policy of ‘winning hearts and minds’, but it does not fulfill Policy Letter 92-1 requirement of formulating policy. (A several minutes long video of the incident was viewable at: http://www.flurl.com/uploaded/Bareknucklepoliticscom_EXCLUSIVE_10122.html, but is no longer available)

the activities in Iraq were considered non-existing capabilities or exceeding current government capacities, the contract itself (not the activity) was awarded competitively. This eliminated government agencies from the competition. But some contracts were not competed. As mentioned before, Kellog, Brown & Root won a no-bid contract because the Government declared that no other company could do that job (Avant). This is a claim that is denied by other firms who believe they could perform the same tasks.

LOGCAP contracts are somewhat questionable with regard to competitiveness. Awarded competitively as an envelope contract in advance to cover potential requirements in the initial phases of a deployment (180 days),⁴⁹ they are used for several years in Iraq. Individual functions are now automatically awarded to the LOGCAP contractor without further bidding.

Even if a competition is performed, it might not comply with the words or the spirit of the laws. Companies can gain advantages in the process when they are participating in the formulation of job requirements and then later compete for the same job. Claims of bid-rigging have also surfaced, brought up by the press or competitors that failed to secure a contract.

Questions to consider:

- Is the award preceded by a true competition?
- Do the circumstances require to award without a competition?

3. Provider Performance Must Be Technically Acceptable

This criterion mostly supports outsourcing in Iraq.

Technical acceptability at the time of the contract award is determined by the source selection authority. It is based on requirements and the contractor's proposal on how to achieve these. This looks as if it is a relatively straight forward determination. In actuality, the decision includes some risk, as it is also a prediction that the contractor will

⁴⁹ Compare with CON234 7 – 19.

indeed perform to the acceptable level when executing the contract. The regulations partly address this problem with an evaluation of past performance of the contractor (for a similar contract). But adequately evaluating past performance and applying it to a new contract can be complex. The Army's purchase of bullet proof vests from Point Blank, after controversies between this company and the Marine Corps about some vests failing testing, is one such example.⁵⁰ Kelly points to Bechtel, which "hired three subcontractors in Iraq that have been fined more than \$86 million in the past four years, though none had been banned from getting new contracts." He quotes Peter Singer in saying that the government does not make the firms pay the price for failure. Frontline quotes an audit by the Office of the Special Inspector General for Iraq Reconstruction that concludes that "there is no assurance that Aegis is providing the best possible safety and security for government and reconstruction contractor personnel and facilities."

When deciding about technical applicability, the authorities must also decide whether similar civilian and military services are indeed identical. One could argue that a civilian child care center faces different challenges than its military equivalent. The safety precautions around the Pentagon child care center after the attacks of September 11, 2001 seem to indicate that there are at least some differences.

4. The Lowest Cost Provider Must Be Selected

This criterion supports the sourcing decision, but there is not enough available data to determine if the cost information on which the decision is based is accurate.

The cost determination is basically based on the government requirements definition, the contractor's interpretation of it and his consequent determination of costs to fulfill those requirements. GAO report [GAO-04-854](#) points out that the government is often not effective in formulating its requirements. As a result, the costs quoted by the contractor do not necessarily reflect the later, actual costs. Furthermore, the collection of actual costs incurred by contracts seems to be also flawed. GAO report [GAO-05-966](#) states that program offices lacked reliable cost data for the investigated performance based logistic contracts. The offices also did not update the business cases after the

⁵⁰ Compare with Lowe.

contract award and were consequently unable to determine if the contracts resulted in cost savings (Government Accountability Office, [GAO-05-966](#)). Frontline argues that firms are not keeping good records either.

While government regulations control the comparison of costs, the actual determination of these costs appears to be often based on assumption and inadequate requirements. This would lead to the whole process being flawed. Also, fraud is not unheard of. Kelly lists several companies in his article that have paid more than U.S. \$ 300 million penalties to resolve allegations of bid rigging and other offenses.⁵¹

5. Estimate ‘All Other Costs and Expenditures’ of Outsourcing

This criterion is very hard to determine as it is nearly impossible to determine if ‘all’ potential costs and expenditures have been considered in an analysis. But the following list should give some examples of what needs to be taken into account.

- The SAALT webpage’s FAQs addresses a number of administrative issues that could have an impact for getting a contract in an area of combat operations. Examples are: “What Labor Laws Apply to Deployed Contractors?”; “What About Contractor Accountability?”; “What Mission Training will be Given?”; “What About Hostage Aid?”, “What About Workers Compensation?”; “What about Medical and Dental Care?”; “What About Uniforms?”; etc. These questions not only affect the performance of some of the stakeholders, but also have a direct economic impact, as many of them will influence the final cost of a contract, either if the government covers some of these risks directly or pays for them through the contract.
- Bailey reminds the reader that privatization of a service does not relieve the government automatically of its responsibilities and therefore incurs a “continuing need to regulate” (148). With regard to issues of public safety

⁵¹ This involves government contracts in general, not only in Iraq.

and public service, he explains that regulation will always be required “to ensure that the public need outweighs private interest. And cost will thus be incurred” (148). This responsibility can directly incur costs.

- Another cost affected is the government’s overhead. Outsourcing might reduce the activities of a military unit without immediately leading to a reduction in its number of personnel. The overhead cost per activity increases consequently.
- If the number of people on a military installation gets reduced following the outsourcing of activities, one potential result is the threat of base closure (e.g., BRAC – Base Realignment and Closure). This would incur costs in the form of relocation, environmental clean-ups etc. (see also economic effects below).
- The argument that the Army can use money saved through outsourcing to finance other activities requires some careful budgetary planning. The particulars of the government budget system can result in lower funds for a following fiscal year, when money was saved the previous year.
- Use of contractors can lead to additional requirements for the military that otherwise would have been part of the now outsourced activity. Soldiers having to protect and defend contractors in addition to their other duties are one such example. The contract with Halliburton for support operations in Iraq, for example, included a case that required the military to provide security for Halliburton’s truck convoys (Frontline). The Army realizes that their reliance on civilian contractors in a combat zone creates operational cost and requires the allocation of “precious resources” (Bolton, Memo 11 June 2002).

- Finally, the analysts have to consider the costs resulting from a failure of the outsourcing.

6. Examine the Potential Economic Effects of Outsourcing

Although no exact data is available for the economic effects of outsourcing during OIF, in general, this criterion supports the decision to outsource activities in Iraq.

The question whether to employ private companies in a combat environment is more than a 'best business' decision, "it is a political issue enmeshed in economic and social considerations" (Campbell 3). The military is not only used to implement the foreign policy of an administration, it also is often used to propagate other policies. Being one of the biggest spenders in the U.S. economy, the government can have a great influence on the marketplace through its procurement regulations. The same principles also apply to the economies of other countries involved in OIF, especially Iraq itself. This paper only considered the economic effects of outsourcing military tasks. It does not take into account the general impact of the war itself onto the economy due to higher budgetary costs or rising oil prices or the resulting opportunity costs of an increased spending on defense.

Without detailed numbers, it is nearly impossible to determine the exact economic effects of each outsourced contract. The following list, however, provides a sample of arguments that would indicate that having the necessary tasks performed by civilian companies, rather than U.S. forces, is economically advantageous.

- The increasing use of reserve units and National Guard can have a disruptive effect on the economy in the U.S. According to Brinegar, 37% of the forces in Iraq in spring 2004 are reservists (181). The companies that employ these soldiers have to either find temporary, but long-term, replacements or suffer from an empty billet. Brinegar lists findings of a 'Reserve Employer Survey,' which states that more than one third of the businesses believe that the increased reliance on reserve components will cause problems for their businesses resulting from the deployment of their employees. Additionally, the buying power of the affected families is

reduced. The Institute for Policy Studies points out that 30% to 40% of these soldiers can earn a lower salary when leaving civilian employment for military duty.⁵² Considering the economy as a whole, this effect is probably compensated by the increase in buyer power of the contractor and his employees.

- The number of new companies, as well as the workload for existing companies, increased with the surge of outsourcing in Iraq. This will result in a larger and probably more efficient industrial base that provides better alternatives for government and other sourcing in the future.
- Most of the provisions mentioned above are discussed from the perspective of the U.S. economy. Generally, the public would expect that the U.S. economy would profit from contracts awarded by the U.S. government and paid for by U.S. tax dollars. In reality, the outsourcing decisions will also impact other countries and their economies. Contracts in Iraq have been awarded to foreign companies and many U.S. companies employ non-U.S. citizens.

There could be long term negative effects of the decision to outsource certain tasks. The DOD is a very large and complex organization. Decisions to contract out might impact other elements that are not even directly involved with the original activity. One such consequence could be what Rendon calls the “ripple effect” (20). He construes that the reduction of personnel in one activity, due to outsourcing, could have the result of decreased demand for other activities, for example officer/enlisted clubs and other facilities (20). The possibility of other activities becoming inefficient for lack of customers and the consequences of potential termination of these activities needs to be considered before the outsourcing decision is made. This is especially true if public

⁵² The Institute quotes Army Emergency Relief in saying that request for food stamps from military families has increased several hundred percent from 2002 to 2003.

employees need to be laid off as a result. Moore emphasizes that in a sample of government employees affected by contracting out; only five percent were left with no employment (68).

Some laws and regulations are supposed to mitigate potentially negative effects of outsourcing on the economy; some do so as a side effect of their original intent. One example is US Title 10 which regulates the amount of business that government organizations have to provide to firms “owned and controlled by socially and economically disadvantaged individuals (as such term is used in section 8(d) of the Small Business Act (15 U.S.C. 637 (d)))” (Title 10, § 2323). A different paragraph of Title 10 requires “[n]ot more than 50 percent of the funds made available in a fiscal year to a military department or a Defense Agency for depot-level maintenance and repair workload may be used to contract for the performance by non-Federal Government personnel” (Title 10, § 2466). While this requirement supposedly should ensure the independence of the military from commercial sources, it also has a positive economic effect on affected communities.

Another law started as a measure to ensure jobs within the U.S. Feingold argues that, when enacted, the purpose of the ‘Buy American’ law ensured that American jobs were ensured by federal procurement policies. Known as the ‘Buy American Act’ (BAA), Section 10 of Title 41 requires that only U.S. materials or products made from U.S. materials should be bought for public use.

Questions to consider:

- Who are the stakeholders that must be included in the analysis to determine the economic benefits and costs of an outsourced contract?

7. Examine the Potential Effects of Outsourcing on the Military Mission

Success of the military mission, as well as the safety of those executing it, should be the first priority. The decision to outsource, even when being the logical choice by

economic standards, cannot lead to a hazard for that success. The following problems result from outsourcing and might pose a danger to the mission or military personnel.

a. Military Discipline and Control

In the absence of a Status of Forces Agreement (SOFA, see Appendix II), a civilian is not responsible for his actions in a criminal sense under U.S. law. Considering the possible drawbacks mentioned when discussing the SOFA, this could result in a civilian operating on the battlefield outside the possibility of prosecution for potential crimes. The Uniform Code of Military Justice (UCMJ) subjects members of the U.S. military to be tried and judged under U.S. jurisdiction in all places (UCMJ 805, Art. 5). This means that a soldier (as defined by this law) cannot escape U.S. justice, just by being outside of U.S. territory. This is a powerful tool that helps the military commander to discipline and command his troops.

As described earlier, this law only applies to contractors in times of war. In that case, the contractors would also be “under direct command, control and discipline of the commander” (Campbell 5). If a war has not been officially declared by Congress and in the absence of a SOFA, a civilian is not responsible for his actions in a criminal sense under U.S. law. The only way a military commander can influence the actions of a contractor in his area of responsibility is through the provisions of the actual contract, as “[c]ommanders have no penal authority to compel contractor personnel to perform their duties or to punish any act of misconduct” (Assistant Secretary of the Army, JP 4-0 V-8).⁵³ JP-04 recommends therefore that the contracts should include disciplinary provisions. The U.S. Congress tried to close that legal gap with the ‘Military Extraterritorial Jurisdiction Act of 2000’ (METJA). It eliminates the necessity that war has to have been declared prior to subject CoB to the UCMJ. Paragraph 3261 of METJA states that:

⁵³ At least not in short term. In a longer perspective, the military can have the company remove an employee who does not follow directions.

(a) Whoever engages in conduct outside the United States that would constitute an offense punishable by imprisonment for more than 1 year if the conduct had been engaged in within the special maritime and territorial jurisdiction of the United States—

(1) while employed by or accompanying the Armed Forces outside the United States; or

(2) while a member of the Armed Forces subject to chapter 47 of title 10 (the Uniform Code of Military Justice), shall be punished as provided for that offense.

(METJA)

Questions to consider:

- Are contractors legally responsible and liable for their action under U.S. or international law when performing the outsourced activity or otherwise?

b. Military and Contractor Safety

JP-04 states that “[f]orce protection responsibility for DOD contractor employees is a contractor responsibility, unless valid contract terms place that responsibility with another party” (Assistant Secretary of the Army, JP 4-0 V-7). This protection also has to encompass all gear (e.g., chemical warfare protection) necessary for the contractor to perform the required tasks. It appears optimistic to believe that a company can guarantee the safety of its employees on the battlefield. Consequently, military planners and commanders need to include enough additional troops in their deployment plan to protect contractors from the enemy.⁵⁴ As a consequence of their status as noncombatants, civilians accompanying a force are only permitted to carry weapons in self defense. The conventions on war interpret this term very strictly. A contractor is not allowed to defend co-workers, company equipment or military personnel

⁵⁴ As mentioned before, this paper will not investigate the effectiveness/efficiency of this process.

and equipment.⁵⁵ Any violation would have the civilians automatically lose their official (and protected) status.⁵⁶ Here, this issue overlaps with the ‘legal status’ concern. Contractors will therefore always remain the responsibility of the military unit in whose area they conduct their activities. It must be ensured that their presence does not negatively impact the troop operations or the safety of the military personnel.

Cooperation with the military makes it necessary that the contractor, at least to some degree, is familiar with details of the military operations that he supports or that are conducted in his area. Before outsourcing activities, it must be unambiguously clear that any knowledge that contractor acquires about these operations cannot get into the wrong hands.

Questions to consider:

- Is the military commander required and able to ensure the safety of contractor personnel in his area of responsibility with the current troop assignment?
- Can contractor activities negatively impact the safety and security of the military personnel and operations?

c. Performance under Military Conditions

No one will dispute that the military often not only operates under different circumstances than a private company, it also has to be able to perform its tasks under rapidly changing conditions (e.g., deployment). Contracts that replace all or some of the activities of military units must therefore ensure that equivalent capabilities are offered. Military units have often a ‘dual use’ capacity. Military cooks, for example, might be able to act as a corpsman, or they have infantry training. If the food processing part of the unit is outsourced, it needs to be determined who is providing the other

⁵⁵ For example, ‘guard duty’ in a rear area could also fall into these categories.

⁵⁶ Zamparelli goes as far to predict that these contractors might become ‘illegal combatants’ (15).

capabilities. The costs and logistic efforts to perform the remaining tasks must be a part of the analysis whether to outsource or not. This is also applicable to the military as a whole. The DOD is able to cover a whole spectrum of operations, from warfare to humanitarian relief efforts. If outsourcing of one function of a military unit results in the decommissioning of the unit, it is essential to evaluate who will take over the other functions.

Obviously, the contractor must also be able to achieve a function under the same circumstances as the original military provider. This includes military standards, where required, high performance requirements, often small lot sizes, rapidly changing requirements, and quickly changing localities. Most importantly, can the contractor execute the contract in a combat environment if it becomes necessary? Lastly, the contractor must be able to integrate his company and employees into a military organization. This is an organizational question as well as a technical (e.g., networking). Joint Vision 2010, for example, requires the complete integration of all logistical components into the operational decision making in a theater of operations in the so called 'Focused Logistics' (Office of the Joint Chiefs of Staff 24). This criterion should be determined when discussing technical applicability. But it needs to take into consideration the fact that the circumstances of a contract can quickly change. Outsourcing maintenance of tactical vehicles might be technically very acceptable in the U.S., but is it still, if the unit deploys into a combat zone.

Questions to consider:

- Are there provisions that would mitigate the military's risk if changing circumstances prevent the contractor from performing the assigned tasks?

d. Long-term Effects on Military Capabilities

One peculiarity of the military is that it has to stay proficient in many capabilities, even if these qualifications are not actively required over extended periods of time (e.g., if there is no war). Outsourcing these activities makes sense in an economical

way, as it will only incur expenditures when the activity is actually performed. There is a possibility that the military will lose the capability to conduct activities which are outsourced for a prolonged time period. Qualified personnel might leave the military, as they are not needed or do not have good career opportunities. The military might incur significant cost if it would have to redevelop a capability that was not performed for a long time within the Armed Forces.

Technical expertise might get lost, if it is not required to stay current with developments in its field. The most qualified people might choose to work for the contractor, as they are often paying more than the government.⁵⁷ “U.S. military leaders have voiced concern that the lure of corporate contractors undermines Army personnel retention—a worry shared by military leaders from Britain to Chile” (Avant). Paragraph 2464 of Title 10 declares that “[i]t is essential for the national defense that the Department of Defense maintain a core logistics capability that is Government-owned and Government-operated.” It then restricts outsourcing by regulating that “performance of workload needed to maintain a logistics capability identified by the Secretary under subsection (a)(2) may not be contracted for performance by non-Government personnel.”

The other long term concern deals with the timeframe that an outsourced service will be available. The military must ensure that the outsourced activity is available, as long as it is required by the Armed Forces (especially considering the issue in the first paragraph). If contracting out the maintenance of a weapon system to a civilian company, the military cannot really predict how long this system will remain in service. And especially in times of decreasing funds, systems are much longer in service than originally anticipated (e.g., B-52 bomber). Nevertheless, the contractor must commit to this unknown timeframe. The less commonly available the offered service is the more important the obligation of the original contractor becomes.

⁵⁷ This argument has surfaced lately especially with regard to Special Forces personnel leaving the Army or Navy to fill the ranks of security companies in Iraq. Of course, the problem itself is not a new one. The Air Force has the same problems with regards to pilots leaving for commercial positions for a long time.

Questions to consider:

- Could the DOD lose capabilities in the long-term (e.g., loss of people or facilities) if they are outsourced for a certain time?
- Are the contractors capable to commit to supporting the DOD, even if required longer than originally predicted?

D. OTHER SOCIO-ECONOMIC ASPECTS

The decision to employ private companies in a combat environment is more than a ‘best business’ decision, “it is a political issue enmeshed in economic and social considerations” (Campbell 3). Heberling and Kinsella see “a number of underlying issues (systemic, cultural, and product), which complicate the adoption of a commercial procurement system by the DOD.” Accordingly, there is a number of additional factors that need to be addressed in the decision making process. It is difficult to put a dollar value on some of them. But their effects on the military are as real as any economic impacts. The following looks at some influential factors that are not specifically covered by the economic or regulatory discussion.

1. Legal Status of Contractors

The legal status of contractors impacts directly their willingness and ability to perform their duties and, in the end, the capabilities of the deployed forces. Furthermore, the legal status can have significant political impacts. The military commander (and of course his superiors as well as the contractor and his company) must be aware under which rules the contractor operates in the area of operations. This is the basis for the contractor’s legal rights and obligations. More importantly, it should determine the treatment the contractor can expect from the opposing forces.⁵⁸ The borders between a combatant and noncombatant are dissolving. Zamparelli notes examples of civilian involvement on the battlefield as the maintenance of TOW⁵⁹ missiles, the Bradley

⁵⁸ There is an overlap with Military Factors here.

⁵⁹ Tube-launched Optically-tracked Wire-guided missile

fighting vehicle, and Patriot missile batteries. Also their support is used in “gathering and interpreting of data from the Joint Air Forces Control Center and feeding intelligence and targeting information to operators?” (15). He continues:

The implications are that, by having a contractor accomplish a particular job, field commanders may be asking them to give up their protected status and even possibly risk execution if captured. Additionally, there is certainly some question as to whether the commander is violating the law of war by having a civilian noncombatant participate in combat. (15)

These issues are addressed in a multitude of international and national laws and guidelines.⁶⁰ Three different categories of laws are applicable. According to the JP 0-4, international, Host Nation (HN) or U.S. law might be relevant (Assistant Secretary of the Army, JP 4-0 V-5). The most important regulations (that might apply individually or in combinations) are listed in Appendix II.

Questions to consider:

- Will contractors conduct the outsourced activity within the protection of U.S. or international law?

2. Political Influence

Military activities need to be funded and appropriated by Congress. Legislators often consider other factors than just the effect on the military in their decision. Elected by the voters in their district, they also need to keep in mind the decision’s effect on their constituency. If outsourcing would impact an important military institution in their region, they are probably less likely to make this decision. If, on the other side, an activity would be contracted to business in their district, thereby securing jobs and tax revenue, they could favor this solution.

⁶⁰ For one listing, see the links on the website of the Assistance Secretary of the Army for Acquisition, Logistics and Technology (SAALT)

Questions to consider:

- Does political pressure influence the decision?

3. Public Opinion

For a government and a legislature determined in general elections, public opinion can become a decisive aspect. Unfortunately, public reaction is hard to predict. It might be hard to foresee whether military or civilian casualties are easier accepted by society, for example.⁶¹ Or to anticipate if employed foreign nationals are regarded as mercenaries or just as workers. Singer identifies some examples where private firms were used to skirt congressional limits on troop numbers or to avoid the public repercussions of calling up the National Guard (37).

Questions to consider:

- Is the use of uniformed personnel or civilian contractors regarded more favorably by the public?
- Which factors can change the public opinion after a decision has been made and what influence does this have on the operation?

4. International Political Effects

The undertakings of the U.S. government are always closely followed around the globe. Any activity that the U.S. is engaged in automatically gains legitimacy in the eyes of many other countries. It also makes it harder for the U.S. to criticize any nation doing what they are doing themselves. Consequently, the increased use of contractors,

⁶¹ While the number of soldiers killed in Iraq gets currently updated in the news nearly on a daily basis, the number of civilians working under government contracts in the same region hardly ever is mentioned.

especially PMFs, makes it fashionable for others to do so too. This includes Third World countries that might otherwise not have the ability to conduct military operations.⁶²

Questions to consider:

- Does outsourcing of certain activities by the U.S. set a precedent that can be used against the U.S. or its policies?

5. Foreign Dependency

In an economy that becomes more and more global, even such laws as the BAA cannot always prevent the military purchasing goods or services abroad. While this might often result in getting the best or cheapest product available, it might come with a certain degree of dependency. The DOD has to evaluate the potential of a foreign government to regulate a company from that country. The foreign power could prevent the company from performing its contracts, or interfere otherwise, if that appears to be in the best interest of that country.⁶³ A theoretical example: the Danish Maersk group has a U.S. \$220 million contract for operating and maintaining eight Roll-on/Roll-off (RoRo) ships (O'Dwyer 24). If these ships were required for a future operation and the Danish government, opposing this operation for political reasons, would forbid Maersk to perform the contract, it might have a significant impact on the U.S. capability to complete the operation.

⁶² See Singer for the implications on international security (19 – 25).

⁶³ During the British-Argentinean conflict about the Falkland Islands, persistent rumors said that the French government had a way to remotely 'defuse' the (French built) MM38 surface/air to surface missiles operated by the Argentinean Navy and Air Force. No matter if that rumor was then true or not, the technological capability exists today and the potentially adverse effects are obvious.

Questions to consider:

- Does outsourcing the activity make the U.S. military dependent on foreign governments?⁶⁴

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6. Organizational and Cultural Barriers

Like all human decision making, the question of contracting out is also influenced by individual human behavior as well as organizational. Heberling and Kinsella list several concerns with the current culture within the DOD that make the processes less effective than their commercial counterparts. They believe that “acquisition personnel frequently need to know more about how to apply the regulations than about the products they buy.” Also, according to them, the “punishment of the innocent” is widely used and publicized in the DOD. Finally, the two authors deem the ‘commercial’ approach to be more labor intensive (e.g., market research, etc.) than the previous government methods, and consequently colliding with the constantly decreasing procurement workforce (Heberling and Kinsella).

Moore questions the willingness of program administrators to decimate the power of their own command by reducing the workforce (67). He doubts that those administrators are likely to make a decision that outsources an activity that was previously conducted by people under their cognizance, thereby reducing their own influence and status.

It can be assumed that all parts of the military share a common set of values (e.g., patriotism, honor, valor, ‘brother-/sisterhood’). Military personnel are, obviously, not driven too much by the compensation they receive. Their motivation is rather intrinsic, based on beliefs, and shared among individuals and organizations. Resulting from these common values is a certain trust among all involved. They depend on the fact that the success of the mission and caring for the soldiers involved are the top priorities of everybody. While many of the former military or law enforcement officers working for PMFs share the same values as their former employees and colleagues, the companies

⁶⁴ There are some clear parallels to the economic principle of Source Dependency. But the implications of international politics go beyond the logics of the market place. Therefore, this issue is listed separately.

themselves might have different beliefs than the organizations they now work for. Rendon classifies the traditional government-contractor relationship as “less-than-cooperative” with both sides “believing that the only way to manage a contract was at the other’s expense” (19). He stresses the necessity of a team partnership between the military and the contractors and that the relationship “requires a mutual commitment to work together to the benefit of both parties” (Rendon 19 - 20). Still, this is a deviation from the old system, where only one party with one goal existed.

Questions to consider:

- Are provisions in place preventing a decision that favors some stakeholders’ interests over those of the U.S. military?
- Does the contractor share the same value system as the customer?

E. CONCLUSION

Many economic criteria do not contradict the outsourcing decisions of military tasks, especially during recent contingency operations and the use of PMFs in Iraq made in Iraq. But in applying those principles and existing government regulations to the situation, some problems also become apparent.

1. Economic Principles are Not Recognized or Utilized

The government did not show a clear understanding of valid economic principles when outsourcing into a non-competitive market or undermining its own relative bargaining power.⁶⁵ The same is true when it states questionable economic arguments

⁶⁵ That some of the decisions are in opposition to the criteria as described in earlier chapters does not necessarily mean that the decision makers did not know what they were doing. From the available sources it cannot be determined if the decision makers were aware of the fact that they acted against some of these criteria. They might have been weighing other factors higher. It nevertheless points to a deficiency in the process, as proper planning should help to avoid being forced to act against recognized principles due to other circumstances.

(as discussed in Chapter II) for justification as to why activities were outsourced. Insufficient analysis of the situation is indicated by lacking management capabilities with reference to outsourced stages, as well as by the high dependency of the military on some sources and the significant investments required to outsource activities.

2. Regulations are Not Followed or are Applied Incorrectly

Some competitions were flawed, either due to ‘bid rigging’ or due to overwriting government policies. The delivery of technically acceptable performance is also somewhat hampered by insufficient requirements on the part of the military or by firms delivering work that did not live up to their promises. Below standard past performances by companies is also not necessarily a factor in the decision process.

3. Regulations are Not Sufficient

What is required by laws and regulations and how these requirements are defined can lead to severe problems in the decision making process. The lack of a clear definition of ‘inherently governmental’ is the factor that probably affects outsourcing in the military the most. Without a legal definition, it is up to the policy makers in the DOD to define functions that are retained by the military. But there is also no published description from the DOD. Title 10 is very broad in its requirement to consider ‘all’ economic and military effects. Without better guidance as to which effects might need investigation and how to perform it, many factors (especially long term) could be neglected. Furthermore, in just requiring ‘consideration,’ it is again up to the selection authority which value it gives these factors on the outcome of the decision. This is even more apparent, as the A-76 circular gives very detailed instructions which costs, for example, have to be included, without including ‘all.’

4. The Military is Different from a Company

The purposes and actions of a company in the commercial market and those of the DOD might be subject to the same economic principles, but their ultimate goals are different. While operating efficiently and effectively is important for the military, it is

not the only factor influencing the process, probably not even the most important. The sourcing for the DOD can be even more affected by government policies, other socio-economic factors, and by the success of the military operation. Sourcing authorities must be aware of all these factors, weigh them against each other and make their decision accordingly.

V. CONCLUSION

“The first responsibility of a leader is to define reality.”

*Max de Pree*⁶⁶

“The only irreplaceable capital an organization possesses is the knowledge and ability of its people.”

*Andrew Carnegie*⁶⁷

A. INTRODUCTION

This chapter summarizes the current situation based on the analysis in the earlier chapters. It concludes that problems exist and shows their causes. It recommends measures to resolve or mitigate these problems. The chapter also suggests areas for further research.

B. SUMMARY

The use of contractors for activities within the DOD and military in general, and particularly during OIF, is wide spread and apparently favored by current government policy. This seems to follow a trend that the commercial market place is the most efficient and effective way to perform these tasks. It includes the appearance of contractors on battlefields, sometimes even their involvement in combat. The conditions that are influencing the source of DOD/military activities can be summarized as follows:

- Laws and regulations, as well as current policy, require the government to competitively source all not ‘inherently governmental’ activities
- ‘Inherently governmental’ is not conclusively defined and its meaning can change over time
- Economic criteria are applicable to the military’s sourcing decision

⁶⁶ As quoted in Microsoft Encarta College Thesaurus (1138).

⁶⁷ As quoted in Microsoft Encarta College Thesaurus (1125).

- Laws and regulations can override economic reasoning for policy purposes
- Military operations follow different rules than commercial activities

Recent outsourcing decisions show that problems exist with applying economic principles. Furthermore, existing regulations are not sufficient to cover the process.

C. CONCLUSION (EXECUTIVE SUMMARY)

The following problems have been identified in the process leading to a sourcing decision in the military:

- The military is different from a company
- Existing regulations are not followed
- Economic criteria are not applied
- Laws and regulations are not sufficient

The first two problems are not considered to require much action, although realizing the difference between military and company influences the suggested modifications to regulations. The last two however, make changes necessary to the way government personnel understands economic principals and to the laws and regulations that control the process. The suggested alterations are listed in the ‘Recommendations’ paragraph.

D. CONCLUSION (DETAILED)

The elements required for a valid sourcing decision exist in the current process and are, at least partially, applied by the decision makers. But the process is handicapped by several problems that can lead to sourcing decisions that are potentially endangering the economic or military success of the concerned activity. Those problems are:

1. The Military is Different from a Company

The military being different from a company is a problem in the sense that it can negatively affect the process. It is not a problem in the sense that it needs to be solved by transforming the military into a company. Some of the military's actions and processes might be or become commercial-like, as suggested by the 'Blue Ribbon Commission,' but it should not be transformed into a commercial entity. But from the understanding that differences exist and will continue to exist follows the consequence that considerations for when to outsource an activity go beyond economical reasons. This situation is already partly addressed in existing regulations and will be further discussed in the respective paragraph.

2. Existing Regulations are Not Followed

That regulations are not being followed or are circumvented is obviously always problematic. It might be a sign that the regulations do not match the requirements of reality. This seems not to be the case in the examples examined for this paper. Either 'honest' mistakes were made due to inexperience or to acting under pressure, or the regulations were overruled by policymakers due to different priorities. Also, some companies might have tried to bypass the regulations to their advantages. In general, this appears to be mainly a managerial or supervising problem. While it deserves the attention of those making the decisions as well as their superiors, it does not have the most critical impact on the process. Additional education of personnel and increased oversight should reduce this factor significantly.

3. Economic Criteria are Not Applied

The case examples show that some outsourcing decisions were made when the economic criteria suggested performing the activity in-house. For most cases the arguments suggest that the economic principles were not overruled by more important factors. It appears that the decisions were economically based but

- applied the wrong valid criteria
- applied valid criteria incorrectly
- applied questionable criteria

This indicates a lack of understanding of the economic principles that control the sourcing decision by the decision makers.

4. Laws and Regulations are Not Sufficient

The existing laws and regulations are not sufficient to ensure that the decision makers find the correct balance between economic effects of their sourcing decisions, effects on the military operations, effects on government policies, and other socio-economic effects.

Title 10 requires the decision maker to consider all economic and military consequences. This statement is too broad, as it gives no real guideline on what ‘all’ includes, and it is also not strict enough, as it does not clearly enough define what ‘considering’ encompasses. It is to a large extent up to the decision maker (and his or her experience and workload) which consequences are included in the process, to what detail they are investigated, and how they are weighed.

Circular A-76, on the other hand, provides a magnitude of detailed instructions regarding how to calculate costs when comparing government and commercial activities. As detailed as these instructions are, they provide a false sense of mathematical correctness of the outcome. Many of the inputs are predictions and guesses and often need to be revised later. The calculations also neglect long term effects and costs for either party. Consequently, the ‘lower cost’ competitor at the time of selection does not necessarily deliver at the low cost estimate on which it was selected.

Finally, the current government policies towards priorities for military sourcing need to be more clearly formulated. All laws and regulations as well as public statements by policymakers agree that outsourcing is a tool that the DOD wants to apply extensively. But the priorities between economic aspects and all other factors is not stated as uniform.⁶⁸

⁶⁸ This is a logical consequence from the fact that the variety of written laws, regulations, and implementation guidelines and public statements on this subject stem from different years, different administrations and sometimes different persons within the same administration.

E. RECOMMENDATIONS

1. Increase Education on Economic Aspects of Sourcing

Valid principles exist that can help to evaluate the economic foundation of a sourcing decision. Decision makers are more and more required to justify their decisions with economic reasons. While it is not very likely that the DOD will become a commercial run entity, it will become more commercial-like. Without substantial knowledge of economic theories, they will be unable to apply these important concepts successfully to the decision process. Without a sound economical evaluation of the situation, all other factors cannot be put into the correct context.

2. Formulate Directions on How to Evaluate Non-economical Factors

With decision makers being under constant pressure to act ‘economically,’ there is a danger that other factors, especially when not having short term negative effects, are being neglected. The directions need to offer the necessary guidance so no consequence can be overlooked. They also should provide sufficient information and help to allow a realistic evaluation of those consequences. The ‘Questions to consider,’ as raised in the previous chapter, are supposed to give the decision makers an idea what consequences they might need to assess and be concerned about. All the questions are listed in Appendix IV.

3. Formulate and Publish a Consistent Policy on the Priorities within the Sourcing Process

Policy makers within the DOD must be aware that any sourcing decision comes with a wide range of direct and indirect cost to all stakeholders. They must therefore clearly define, and put in writing, what their priorities are and how the lower level decision makers can ensure that their process helps to implement those priorities correctly. All pertinent publications must either reflect the same policy or be formulated broad enough to accommodate it within its text.

4. Increase Consideration of Valid Economical and Non-economical Factors in the Sourcing Decision

Based on the increased knowledge of economic principles and the improved guidance on the evaluation of other factors, the decision makers must include these factors in the process. Justification of any sourcing decision must include comments on the expected results in economic, military, and socio-economic turns, as well as an explanation of the priorities assigned to each issue.

5. Increase Management Capabilities for Outsourced Contracts

If an activity is outsourced, it does not automatically mean that the military can leave everything to the contractor. The last responsibility for the activity will always lie with the government. It is also the military that will suffer the consequences of the contractor's actions. To ensure competent and real time management of all contracts, the military has to have enough contracting officers and train them to deal with the companies on the same level. Additionally, the management structure must be flexible enough to support the requirements of military combat operations.

6. Conduct Studies to Evaluate Results of Sourcing Decisions

To ensure a constant high standard in sourcing decisions, the process must be constantly monitored. This includes long term data collection, starting with the decision itself, including actual data and all predicted outcomes on which the final decision was based, the performance and management of the activity, and the final result. Studies should be conducted that especially analyze predicted effects of the sourcing choice at the time the decision was made and the actual effects experienced. This would advance the process of predicting future consequences and thereby help to improve the basis on which a decision is made.

F. RECOMMENDED FURTHER RESEARCH

This paper mostly investigated the economic principles and applicable regulations that influenced some recent decisions to outsource military activities. The following

topics for further research can help to evaluate the outcome of these decisions and investigate alternative approaches to the sourcing question.

1. Long-term Effects of Outsourcing

Research should evaluate if the outsourcing resulted in the expected/predicted outcome and if there were additional results that were not a factor in the original decision process but that, if integrated, could have influenced it.

2. Alternative Sourcing

Total outsourcing and complete in-house execution of activities are only the two extremes of quite a variety of possible solutions to the sourcing question. Further research should investigate if alternative methods and variations exist that could be more advantageous for the military. Examples for such methods⁶⁹ could include Long Term Contracts;⁷⁰ Value Adding Partnerships;⁷¹ Leasing;⁷² or Joint Ventures.⁷³

3. Economical Behavior

If the military becomes a more commercial-like organization, it also will have to adopt commercial behavior and principles and consequently be run by commercial guidelines. Some of these principles will be against current doctrines and policies, e.g., long term contracts with suppliers. Before adopting these principles, studies should investigate which laws, rules, and regulations would be opposed to the changes and for what reasons.

⁶⁹ Compare Baye (204).

⁷⁰ Compare with Grant (325) and Brickley, Smith, and Zimmermann (527).

⁷¹ Compare Grant (325).

⁷² Compare Brickley, Smith, and Zimmermann (529).

⁷³ Compare Coughlan (1).

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APPENDIX I – INHERENTLY GOVERNMENTAL FUNCTIONS

The following is an extract from Policy Letter 92-1. It lists inherently governmental functions:

The following is an illustrative list of functions considered to be inherently governmental functions: (footnote: With respect to the actual drafting of Congressional testimony, of responses to Congressional correspondence, and of agency responses to audit reports from the Inspector General, the General Accounting Office, or other Federal audit entity, see special provisions in subsection 6(c) of the text of the policy letter)

1. The direct conduct of criminal investigation.
2. The control of prosecutions and performance of adjudicatory functions (other than those relating to arbitration or other methods of alternative dispute resolution).
3. The command of military forces, especially the leadership of military personnel who are members of the combat, combat support or combat service support role.
4. The conduct of foreign relations and the determination of foreign policy.
5. The determination of agency policy, such as determining the content and application of regulations, among other things.
6. The determination of Federal program priorities or budget requests.
7. The direction and control of Federal employees.
8. The direction and control of intelligence and counter-intelligence operations.
9. The selection or nonselection of individuals for Federal Government employment.
10. The approval of position descriptions and performance standards for Federal employees.
11. The determination of what Government property is to be disposed of and on what terms (although an agency may give contractors authority to dispose of property at prices with specified ranges and subject to other reasonable conditions deemed appropriate by the agency).
12. In Federal procurement activities with respect to prime contracts,
 - (a) determining what supplies or services are to be acquired by the Government (although an agency may give contractors authority to acquire supplies at prices within specified ranges and subject to other reasonable conditions deemed appropriate by the agency);

- (b) participating as a voting member on any source selection boards;
 - (c) approval of any contractual documents, to include documents defining requirements, incentive plans, and evaluation criteria;
 - (d) awarding contracts;
 - (e) administering contracts (including ordering changes in contract performance or contract quantities, taking action based on evaluations of contractor performance, and accepting or rejecting contractor products or services);
 - (f) terminating contracts; and
 - (g) determining whether contract costs are reasonable, allocable, and allowable.
13. The approval of agency responses to Freedom of Information Act requests (other than routine responses that, because of statute, regulation, or agency policy, do not require the exercise of judgment in determining whether documents are to be released or withheld), and the approval of agency responses to the administrative appeals of denials of Freedom of Information Act requests.
 14. The conduct of administrative hearings to determine the eligibility of any person for a security clearance, or involving actions that affect matters of personal reputation or eligibility to participate in Government programs.
 15. The approval of Federal licensing actions and inspections.
 16. The determination of budget policy, guidance, and strategy.
 17. The collection, control, and disbursement of fees, royalties, duties, fines, taxes and other public funds, unless authorized by statute, such as title 31 U.S.C. [[section]] 952 (relating to private collection contractors) and title 31 U.S.C. [[section]] 3718 (relating to private attorney collection services), but not including:
 - (a) collection of fees, fines, penalties, costs or other charges from visitors to or patrons of mess halls, post or base exchange concessions, national parks, and similar entities or activities, or from other persons, where the amount to be collected is easily calculated or predetermined and the funds collected can be easily controlled using standard cash management techniques, and
 - (b) routine voucher and invoice examination.

18. The control of the treasury accounts.
19. The administration of public trusts.

This second extract from Policy Letter 92-1 lists functions that are not governmental:

The following list is of services and actions that are not considered to be inherently governmental functions. They may approach being in that category because of the way in which the contractor performs the contract or the manner in which the government administers contractor performance. When contracting for such services and actions, agencies should be fully aware of the terms of the contract, contractor performance, and contract administration to ensure that appropriate agency control is preserved.

This is an illustrative listing, and is not intended to promote or discourage the use of the following types of contractor services:

1. Services that involve or relate to budget preparation, including workload modeling, fact finding, efficiency studies, and should-cost analyses, etc.
2. Services that involve or relate to reorganization and planning activities.
3. Services that involve or relate to analyses, feasibility studies, and strategy options to be used by agency personnel in developing policy.
4. Services that involve or relate to the development of regulations.
5. Services that involve or relate to the evaluation of another contractor's performance.
6. Services in support of acquisition planning.
7. Contractors' providing assistance in contract management (such as where the contractor might influence official evaluations of other contractors).
8. Contractors' providing technical evaluation of contract proposals.
9. Contractors' providing assistance in the development of statements of work.
10. Contractors' providing support in preparing responses to Freedom of Information Act requests.
11. Contractors' working in any situation that permits or might permit them to gain access to confidential business information and/or any

- other sensitive information (other than situations covered by the Defense Industrial Security Program described in FAR 4.402(b)).
12. Contractors' providing information regarding agency policies or regulations, such as attending conferences on behalf of an agency, conducting community relations campaigns, or conducting agency training courses.
 13. Contractors' participating in any situation where it might be assumed that they are agency employees or representatives.
 14. Contractors' participating as technical advisors to a source selection board or participating as voting or nonvoting members of a source evaluation board.
 15. Contractors' serving as arbitrators or providing alternative methods of dispute resolution.
 16. Contractors' constructing buildings or structures intended to be secure from electronic eavesdropping or other penetration by foreign governments.
 17. Contractors' providing inspection services.
 18. Contractors' providing legal advice and interpretations of regulations and statutes to Government officials."
 19. Contractors' providing special non-law enforcement, security activities that do not directly involve criminal investigations, such as prisoner detention or transport and non-military national security details.

APPENDIX II – LEGAL ISSUES CONCERNING CONTRACTORS ON THE BATTLEFIELD

The following are the major laws that apply to the employment of contractors on the battlefield.

A. STATUS OF FORCES AGREEMENTS (SOFA)

SOFAs provide for the status of members of Armed Forces present within the territory of another nation (Assistant Secretary of the Army, JP 0-4 V-5). SOFAs are bi- or multilateral agreements “between [...] governments that provide various privileges, immunities and responsibilities, as well as enumerating the rights and responsibilities of individual members of the deployed force” (SAALT, FAQs: “What are Status of Force Agreements?”). While a SOFA could be the most detailed regulation pertinent to CoBs, there are some potential drawbacks:

- Most existing SOFAs do not cover contractors
- Future requirements of potential contractor work must be accurately predicted at the time of SOFA negotiations/signature
- SOFA requires interdepartmental (DOD, DoS) coordination
- A SOFA is most unlikely to be honored in case of hostilities between the parties

B. CONVENTIONS ON WAR

Both The Hague and the Geneva Conventions require combatants to be subordinate to a military superior and a disciplined organization.⁷⁴ This is clearly not the case for contractors, as they are supervised and managed by their company, while contract performance is the responsibility of a Contracting Officer (KO).⁷⁵ Both conventions recognize the status of a ‘civilian accompanying a force’ as long as they

⁷⁴ Compare: The Avalon Project: “Laws and Customs of War on Land (Hague II) of 1899” and The Avalon Project: “Geneva Convention (III) of 1949.”

⁷⁵ Compare: SAALT FAQs: “How are Contractors Managed?”

have a valid authorization from the force they are associated with. This would grant contractors a Prisoner of War (POW) status when captured.

C. HOST NATION LAW

In the case that no other international laws or other bilateral regulations apply, the contractor is subject to the national laws of the host nation, or in other words, the country the contractor is acting in. Obviously, these laws can differ dramatically from country to country. Negative aspects to consider include:

- A very confused situation if no law (or government) exists (e.g., Somalia 1994)
- A contractor might be acting outside any jurisdiction, as no U.S. administration ever favored extraditing U.S. citizens to other jurisdictions, even to friendly governments
- HN laws might be not considered adequate from a ‘Western’ point of view⁷⁶

D. U.S. LAWS

U.S. laws only affect a civilian when he/she is located within the U.S.’s “special maritime and territorial jurisdiction,” (Campbell 6) or when the Uniform Code of Military Justice (UCMJ) applies to him or her. The UCMJ is a criminal law normally covering U.S. military forces⁷⁷ anywhere in the world. It explicitly is extended to “persons serving with or accompanying an armed force in the field,” but only in a time of war (UCMJ 802, art. 2, (10)). U.S. laws might also be applicable in form of labor contracts, etc.

⁷⁶ As Zamparelli emphasizes “In countries where justice is based upon the Talmudic code—an eye for an eye—this could be extremely important” (16).

⁷⁷ For an exact definition of who is covered, compare UCMJ, 802 Article2.

APPENDIX III – CALCULATING PUBLIC-PRIVATE COMPETITION COST FIGURES

The following is an attachment to circular A-76:

OMB Circular No. A-76 Attachment C May 29, 2003 Calculating Public-Private Competition
Costs Figure C1.

Table of Standard A-76 Costing Factors⁷⁸

Title	Originating Source	Category of Cost	Factor ¹
Casualty Insurance Cost Factor	OMB Transmittal Memoranda	Non-pay	0.5%
Civilian Position Full Fringe Benefit Cost Factor	OMB Transmittal Memoranda	Pay	32.85%
Contract Administration Cost Factors and Allowable Grades	OMB Circular A-76	Pay	Figure C6.
Conversion Differential	OMB Circular A-76	Non-pay	10% or \$10 million
Cost of Capital Cost Factors	OMB Circular A-94, Discount Rates to be Used in Evaluating Time-Distributed Costs and Benefits (Appendix C)	Non-pay	Depends Upon Capital Asset
Insurance and Health Benefit Cost Factor	OMB Transmittal Memoranda	Pay	5.7%
Federal Insurance Contribution Act (FICA) Cost Factor ²	Social Security Administration	Pay	7.65%
Federal Wage System (FWS) Pay Schedules	Civilian Personnel Management Service Wage and Salary Division	Pay	Multiple Wages
Foreign Country Operations & Maintenance Inflation Cost Factors	Local Determination	Non-pay	Depends Upon Location
Fuels Inflation Cost Factors	Office of the Under Secretary of Defense (Comptroller), National Defense Budget Estimates for the FYxx Budget (Green Book)	Non-pay	Depends Upon Fiscal Year
Full-Time, Part-Time & Temporary Annual Productive Hours for Civilian Positions	OMB Circular A-76	Not Applicable	1,776 Hours
General Schedule (GS) Pay Schedules	OPM Office of Compensation Administration	Pay	Multiple Salaries
Intermittent Annual Productive Hours for Civilian Positions	OMB Circular A-76	Not Applicable	2,007 Hours
Labor Inflation Cost Factors for Civilian Positions	OMB Transmittal Memoranda	Pay	Depends Upon Fiscal Year
Labor Inflation Cost Factors for Military/Uniformed Services Positions	OMB Transmittal Memoranda	Pay	Dependent Upon Fiscal Year
Medicare Benefit Cost Factor	Social Security Administration	Pay	1.45%
Military/Uniformed Services Composite Pay Rates	Military Departments: Office of the Under Secretary of Defense (Comptroller) FYxx Department of Defense Reimbursable Rates Tab K (All Services) Other Uniformed Services: Dependent Upon Agency Comptroller Determination	Pay	Depends Upon Uniformed Service and Fiscal Year
Miscellaneous Fringe Benefit Cost Factor	OMB Transmittal Memoranda	Pay	1.7%

⁷⁸ From OMB Circular A-76, page C4

Non-Appropriated Fund Pay Schedules	Civilian Personnel Management Service Wage and Salary Division	Pay	Multiple Wages
Old Age and Survivors Death Insurance Maximum Taxable Earnings (salary limit)	Social Security Administration	Pay	\$87,000
Old Age and Survivors Death Insurance Cost Factor	Social Security Administration	Pay	6.2%
Operations & Maintenance Inflation Cost Factors	Office of Management and Budget Transmittal Memoranda	Non-pay	Depends Upon Fiscal Year
Overhead Factor	OMB Circular A-76	Pay and Non-pay	12%
Personnel Liability Insurance Cost Factor	OMB Transmittal Memoranda	Pay	0.7%
Other One-Time Conversion Cost Factor	OMB Circular A-76	Non-pay	1%
Severance Pay One-Time Conversion Cost Factor	OMB Circular A-76	Pay	4%
Special Class Retirement Cost Factor (Law Enforcement & Fire Protection)	OMB Transmittal Memoranda	Pay	38.2%
Special Class Retirement Cost Factor (Air Traffic Control)	OMB Transmittal Memoranda	Pay	33.0%
Standard Civilian Retirement Benefit Cost Factor	OMB Transmittal Memoranda	Pay	24.0%
Tax Rates	Internal Revenue Service Statistics of Income Division Statistics of Income Corporation Sourcebook and North American Industry Classification System	Non-pay	Depends Upon Industry Grouping in Source Document
Useful Life and Disposal Values	OMB Transmittal Memoranda	Non-pay	Depends Upon the Capital Asset

¹ The factors listed in this column are factors in effect on the publication date of this circular. ² For social security (i.e., Old Age and Survivors Death Insurance and Medicare).

APPENDIX IV – ‘QUESTIONS TO CONSIDER’

This is a listing of all ‘questions to consider’ that were raised in Chapter IV (regrouped in similar topics):

- Does the DOD consider existing competition in the market place when requesting a proposal and negotiating the contract?
- Can the DOD influence the bargaining power to its advantage via the timing of negotiations?
- How can the source dependency risk be mitigated?
- Are the direct and indirect costs of mitigating the risk included in the cost analysis?
- Who bears the financial risk of investments resulting from the sourcing decision?
- Who are the stakeholders that must be included in the analysis to determine the economic benefits and costs of an outsourced contract?
- Are provisions in place preventing a decision that favors some stakeholders’ interests over those of the U.S. military?
- Is the award preceded by a true competition?
- Do the circumstances require to award without a competition?

- Who determines the factors that decide what inherently governmental is?
- What is the impact on military operations if investments are not/not fully made?
- Are the contractors capable to commit to supporting the DOD, even if required longer than originally predicted?
- Are there provisions that would mitigate the military's risk if changing circumstances prevent the contractor from performing the assigned tasks?
- Does the local military commander have the means to utilize contracts in a way that supports his operations in a timely manner?
- Is the military commander required and able to ensure the safety of contractor personnel in his area of responsibility with the current troop assignment?
- Can contractor activities negatively impact the safety and security of the military personnel and operations?
- Are processes available that help the government to evaluate the security in commercial companies?
- Will contractors conduct the outsourced activity within the protection of U.S. or international law?
- Are contractors legally responsible and liable for their action under U.S. or international law when performing the outsourced activity or otherwise?

- Are processes in place that determine the exact 'need to know' for commercial companies?
- Could the DOD lose capabilities in the long-term (e.g., loss of people or facilities) if they are outsourced for a certain time?
- Does political pressure influence the decision?
- Is the use of uniformed personnel or civilian contractors regarded more favorably by the public?
- Which factors can change the public opinion after a decision has been made and what influence does this have on the operation?
- Can avoiding regulations be interpreted as cheating and what effect does this have on achieving the government's policies?
- Does outsourcing of certain activities by the U.S. set a precedent that can be used against the U.S. or its policies?
- Does outsourcing the activity make the U.S. military depending on foreign governments?
- Does the contractor share the same value system as the customer?

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