



February 21, 2014

### **Letter from Washington**

The Congress performed some budgetary magic earlier in the year and agreed on a spending plan for 2014 and 2015 that provides significant relief to the DoD for those two years at least. Absent that agreement, sequestration reductions would have eliminated \$85B from the DoD budget by 2021. Instead, the Department has had \$22.4B added back in on top of the \$498B cap required by current law. This was done by a combination of adjusting the cap upward and by adding to the Overseas Contingency Operations fund for war spending.

The Service Chiefs have been increasingly vocal regarding the dire potential for their organizations, even with the increased budget flexibility. The Army has declared that a force of 450,000 is the minimum capable to carry out the National Military Strategy, and reverting to the sequestration numbers would put it on a steep glide slope to 420,000 in uniform. The Navy said that it would have to consider retiring the carrier USS George Washington rather than complete its mid-life reactor refueling and overhaul. These budgetary gambits are known as the "gold-watch strategy" in the Pentagon, and have always been effective. The service offers up something to cut that is so valuable and strategically necessary that it makes the appropriators flinch.

Something also happened this past month in that regard that is interesting and telling. The Service Chiefs and the Chairman have always had offline relationships with the key members of the Congressional authorization and appropriations committees. For many years, the appropriators would invite the Chiefs to provide lists of items that they would like to have, but that didn't make the cut internally in the Service's budget process. These "unfunded requirements" lists had the effect of providing a pipeline for the Chiefs direct to the Congress, going around the Secretary of Defense and ignoring the President's budget, while allowing Defense-minded members to plus up the DoD budget, usually with their pet rocks.

Former SECDEF Gates put a stop to the practice in 2009 by requiring the Chiefs to submit the lists through him, which he then never passed on, effectively ending the practice. It also provided a teachable moment for the Department of Defense that the civilian Secretary was in charge.

Fast forward now to 2014, and consider the metamorphosis that current Defense Secretary Hagel has undergone. When nominated for the position, he had the reputation of being an independent minded and clever politician, who frequently spoke out about the bloat in the Defense budget and the broken process. As a former Army sergeant with combat duty, he would have the life experience and the worldview to slash the excess and to stare down the generals and admirals.

After being in the seat for close to a year, Hagel has shown himself to be more like the clueless man at his confirmation hearing than the assertive slasher of unnecessary overhead and wasted resources. As a result, he has actually revived the process of Service Chief wish lists transmitted to the Congress, and encouraged the Chiefs to develop their unfunded requirements. The Congress, delighted to have their backdoor prerogative restored by the SECDEF himself, have enlarged the concept by inviting the Combatant Commanders to submit their own lists as well. Hagel didn't lose control of the process; he seems to have given it away.

So far the Chiefs' 2015 wish list is at \$26B and is being referred to as an "investment fund". In budget compilations the Services each account for future inflation in different ways, some unique, but all in excess of the OMB's forecast GDP rate of inflation for the entire economy. When compared against the average Defense budget during the peak cold war years in constant dollars, the 2014 Defense budget is somewhere between \$50 and \$150B higher. Hagel seems to have been co-opted by the process and is now just along for the ride.

From the defense industry standpoint, the budget agreement has brought some stability, at least temporarily, to a confusing and turbulent couple of years. We are in the fifth major defense drawdown since the end of World War II, none of which were managed well and resulted in degraded readiness to varying degrees. While most agree that tough choices need to be made, it's not clear who is going to start making them. The administration continues to submit budgets that violate the caps, and the Congress refuses to address the hot buttons of base closings, National Guard/Active Force realignment or retiree benefits.

The late budget agreements or Continuing Resolutions over the past several years have caused great programmatic confusion. In addition to having to develop several different budgets to fit varying appropriations levels with or without sequestration, Program Managers in the DoD have had to adjust to funding arriving later in the year than it should. As a result, spending plans have had to be abbreviated into seven or eight months instead of ten or eleven, and any money not obligated due to timing is often taken away the following year causing further programmatic uncertainty.

For the industry, this period may have been confusing and difficult but not the disaster that was forecast. The major defense companies revenues are down only by single digits, and despite the predictions, the industry didn't drop off into the abyss. The defense sector in general has performed well but mainly through productivity enhancements, shedding overhead and other efficiency moves that are not a long-term strategy.

What may be coming up is another round of defense consolidations, as single product area companies attempt to diversify their offerings, and the larger companies acquire their competitors. However that shakes out, what is clear is that the government will be looking to industry to shoulder more of the cost of development. To be successful players, large and small companies will have to be willing to accept the risk inherent in development of technologies without a guaranteed contract, which will require a cultural shift in the boardroom.

With government funded R&D taking a significant budgetary hit, defense companies will have to become more agile in shaping the process, while partnering informally with their government customers to anticipate and influence the requirements process.

In his State of the Union address at the end of January the President let loose a couple of howlers that seem to have gone by without a lot of notice.

The President is in a bad place, largely because of the health care fiasco. The State of the Union address lacked any big ideas or major initiatives, perhaps tacit acknowledgment of his early lame duck status. Increasingly, Americans are not just disillusioned by the stunning incompetence displayed, but they are distrustful of the government in general and of the man himself. 72% of Americans now say that big government is the main threat to the US, including

56% of the President's own party. The President's position has eroded to the point that his prime time address had 19 million fewer viewers than in 2008, and the people who believe they have been lied to are increasingly filtering him out.

He asked rhetorically at one point why it was all right to negotiate with the Soviet Union but not with Iran? There are many reasons that a growing number in the Congress don't trust the President to develop a deal with Iran that will serve the US's long term interest. At this point Obama seems increasingly focused on his legacy, and the urgency to ink a deal with Iran becomes paramount. In the negotiations that have taken place so far, the United States has undercut the UN position on Iranian uranium enrichment, seemingly conceding a major point and loosening sanctions temporarily without getting anything in return. In the speech the President claimed that Iran "has begun to eliminate its stockpile of higher levels of enriched uranium". This brought a swift rebuttal from Iran, saying that they had agreed to nothing of the kind.

Obama will most likely be protected from a Senate bill to increase sanctions in the event of Iranian non-performance in the negotiations by the Majority Leader refusing to allow it to come to the floor. But the number of vulnerable Democrats, already saddled with Obamacare in 2014, may force some consideration. Especially when the evidence mounts that the negotiations are likely to end badly, or worse, with a bad deal.

In foreign affairs particularly the President inhabits a world that bears little resemblance to reality. Even his most ardent supporters are hard pressed to point to a place in the world that is better now than it was in 2008, despite the State of the Union happy talk.

Regardless of the loss by the Russian Olympic hockey team, the juxtaposition of Vladimir Putin and Barack Obama seems striking this week. Assuming that the Olympics conclude without a major terrorist incident, Putin is personally riding high and leading what he hopes will be a resurgence of Russian influence, entirely at the expense of the United States. Think about it: starting with granting asylum to Edward Snowden, Putin has gotten the better of Obama in every part of the world where there was something at stake --- the ongoing human tragedy and strategic disaster in Syria (anybody heard from the chemical weapons lately?); a major realignment of Egypt and Russia through a weapons deal; frustration of the sanctions regime against Iran; and finally the unfolding Ukraine situation.