



DRMI Newsletter

Defense Resources Management Institute, Naval Postgraduate School, Monterey, California

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www.nps.edu/DRMI

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Send Us Your News!



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new newsletter becomes available, we'll send you an email with a newsletter link so you can keep in touch with your classmates and stay informed as to the latest with DRMI. Send your news to DrmAdmin@nps.edu.

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C.J.'s Corner

Comments from Dr. C.J. LaCivita, Executive Director, DRMI



At the end of our courses at DRMI, we never say good bye to our participants. Instead, we say until we meet again because it's a small world, and there's a good chance we'll see each other again. This was reinforced for me on a two-and-half week trip I made at the end

of October. On the trip I visited Montenegro, Serbia and Kazakhstan, stayed overnight in Beijing, China, and in the process flew around the world.

(See "C.J.'s Corner" on page 2.)

Feature Article

New Insights in Defense Management from Transaction Cost Economics, by Dr. Francois Melese



Faced with ballooning budget deficits, growing entitlements, and an aging workforce, the U.S. Government and many of its allies are searching for savings by outsourcing both positions and products. This presents senior defense officials with a dual challenge: First, what

should the Department of Defense (DoD) make itself and what should it buy in the marketplace? Second, if the decision is to buy (or outsource), how can we ensure better outcomes for both the taxpayers and the military?

A new literature called transactions cost economics (TCE) helps answer these two questions. TCE offers useful principles for defense managers, and new insights for cost estimating and defense acquisition.

The "make-or-buy?" decision

Nobel Prize winner Ronald Coase launched the study of TCE in the early 1930s with a simple question: "Why are there firms?" His answer: firms minimize transaction costs. TCE views firms and government organizations as complex webs of contractual relationships among resource owners. Each relationship - the acquisition of an input, employment of a worker, transfer of a product or service from a supplier to a customer - is a transaction. The contribution of TCE is to focus on motivation and management costs of coordinating transactions.

Even where there is an obvious "production cost" advantage to outsourcing, Coase explains that internalizing some transactions may be less expensive than relying on the market. This raises a key question that defines every private and public organization - the "make-or-buy?"

(See "New Insights" on page 5.)

C.J.'s Corner (Continued from page 1.)

Al Polley and I departed Monterey on 30 October en route to Montenegro, the latest state of the former Yugoslavia to become a separate nation. The Montenegrins are in the early stages of organizing their military and an MoD, and the purpose of our visit was to determine if DRMI courses were appropriate for Montenegro at this time. During our talks, the Montenegrins told us that there was a Norwegian officer on assignment there to assist them. When we met him, we recognized him as a graduate of our DRMC. Next, Al and I flew to Belgrade to conduct a four-day seminar on PPB under the sponsorship of the Marshall Center. We had conducted a similar seminar for Serbia at the Marshall Center in December of 2006, and the seminar in Belgrade gave us the opportunity to renew friendships with some of the participants in the previous seminar and with personnel from the Marshall Center. Leaving Belgrade, Al flew to Poland to participate in a seminar there, where he again met some of our graduates. I flew to Vienna and met up with Diana Angelis. Diana and I then flew to Astana, Kazakhstan, where we met with officials from the Kazakh MoD to discuss resources management issues. The leader of the Kazakh delegation was a graduate of our IDMC. It is indeed a small world.

DRMI News

Mexico MET, by Senior Lecturer Don Bonsper



A DRMI team of Dr. Jim Blandin, Dr. Jim Airola and Mr. Don Bonsper (course coordinator) presented a third mobile course in Mexico City 5-9 November 2007. DRMI conducted mobile courses in 2005 and 2006 to officers of the navy, but this course included 10 officers each from the navy and army. The inclusion of participants from both military services was important because the navy and army are in separate ministries and seldom have the opportunity to attend courses together. The main goal of this one-week course was to present a sound approach - both efficient and effective - to high level decision making and resource allocation.

The exercises of Drmecia played a key role in the execution of the course. Comments from the participants were very positive and DRMI expects to return again next year.

DRMI Provides En-route Education to Rear Admiral Kevin Quinn



At the request of the Center for Executive Education, Dr. Natalie Webb organized educational exchanges between DRMI faculty and Rear Admiral Kevin Quinn. Adm. Quinn will soon assume duties as Commander Naval Surface Forces Atlantic (SURFLANT). Adm. Quinn met with Drs.

Kent Wall, Bob McNab, Francois Melese, Natalie Webb and Jim Blandin, Mr. Don Bonsper, Mr. Luis Morales, LTC Mark Hladky and LtCol Chris Page. Discussions focused on defense resources management and included topics such as cost, effectiveness, risk, analytical tools for managing defense resources, PPBE and other budgeting and financial management issues, both theoretic and practical.

DRMI gets a new web address

You may have noticed in the header of this newsletter that the DRMI's web site has a new address. Effective immediately our new address is:

<http://www.nps.edu/DRMI>

This new address was necessitated by NPS' move from the .MIL domain to the .EDU domain.

Participant News

DRMI Congratulates Graduates Who Have Been Promoted

Lebanon elects General Michael Suleiman (SIDMC 95) as President (include photo)

From Smith, Jeff (ed.) (2007, December 12). Lebanon finds a new president. Eurasia Security Watch (164), American Foreign Policy Council, Washington, D.C.

LEBANON FINDS A PRESIDENT



Lebanon's warring political factions appear to have finally settled upon a consensus candidate to fill the vacated post of president. The Western-backed "March 14th" bloc and the Iranian and Syrian-backed coalition led by Hezbollah had been locked in a

political and constitutional crisis for weeks, with each group denying the other's candidate a majority in parliament. The deadlock has finally been broken, however, with all parties involved - including the United States and Syria - settling upon General Michael Suleiman, the commander of the Lebanese Armed Forces, who is widely respected as both a pragmatist and a political moderate. A significant constitutional hurdle still needs to be cleared to allow for a "grade-one" public servant to serve in the office of the president, but most expect Suleiman to take the reigns of power sometime next year. (Beirut Daily Star, November 29, 2007)

Brigadier General Andrzej Falkowski, Polish MoD, (MIDMC 95-5, IDMC 94-3) elected Assistant Director, Logistics and Resources Division, IMS

On November 22, 2007 BG Andrzej Falkowski has been elected for the post of the Assistant Director, Logistics and Resources Division in the International Military Staff (IMS). The Polish general has been elected by the Military Representatives to the Military Committee of NATO. BG Falkowski will be the highest-ranking Polish general serving in the IMS. He will be in charge of the Logistics and Resources Division; will represent the Military Committee and act as chairman and deputy or co-chairman of a number of senior NATO committees including NATO Defence Manpower Committee (NDMC), Senior NATO Logistics Conference (SNLC), Senior Resources Board (SRB), Conference of National Armaments Directors (CNAD) and the Research and Technologies Board (RTB).

LTCOL Radoslav Ivancik, Slovakian Army (SIDMC 07) promoted within the Slovak Armed Forces and EU

LTCOL Radoslav Ivancik writes "since 1/1/2008

I am appointed to the new post, Chief of J-8 of the General Staff of the Slovak Armed Forces, which is the highest post for financial officer in our armed forces. Historically, I am far the youngest officer appointed to that significant post, and I have to emphasize that it is also thanks to my study at DRMI. (DRMI faculty say, "thanks!") LTCOL Ivancik also says he has been chosen also for the position of Chief of the Financial and Economic Section (J-8) of The Joint Operational Command of European Union in Potsdam, Berlin, Germany for years 2009 and 2010. He is sending one of his subordinates Captain Jozef Dedic (senior officer of J-8), to DRMI for the 11-week course starting in February 2008.

FADM Jamil Osman from Malaysian Navy (SIDMC 07) Promoted to Chief of Staff, Joint Operations Headquarters

FADM Jamil Osman writes that he will begin a new assignment on 4 January as the Chief of Staff for the newly established Joint Operations Headquarters, Malaysian Armed Forces.

Col Abood Abdullah Al-Shahrani, Saudi Arabian National Guard (IDMC 07-2) promoted

Col Abood Abdullah Al-Shahrani was promoted to colonel during his stay at DRMI in the fall. He had a small celebration and invited participants and staff to join him.

Class Notes 2007

LTC Hassan Alharbi, Saudi Arabian National Guard (IDMC 07-1, DRMC 07-2, SGOP, OBS and Misc. training), sent his greetings to DRMI and mentioned that his cousin, Hussain Jaber H. Alharbi, will be attending IDMC 08-1.

GP Capt Kit Caesar, Ghana Air Force (IDMC 07-2) writes, "I must express my thanks to the faculty members and the admin staff for their warmth and support during the period of the course. I will cherish the good relations and hope to be a good DRMI ambassador."

Maj Flora Dako, Albanian Army (IDMC 07-2) writes, "Happy New Year and may 2008 be happy, healthy and prosperous for you and your families. Hope for PEACE in the World, joy and happiness. Hope to see you in the future."

Col Eugenio (Lupo) Lupinacci of the Italian Air Force (SIDMC 07) sent DRMI his greetings from

Rome. He started an Instituto Alti Studi Difesa (IASD), which is a Joint Defense Study Institute.

LTC Rich Morales, USA (DRMC 07-1) sent DRMI his greetings as his unit prepares for (yet another) deployment to Iraq. He will meet up with LTCOL(GS) Carsten Hunte of the German Army (a fellow DRMC 07-1 graduate) in Hamburg, Germany.

We are happy to have received greetings from:

Col Turki bin Abdullah Al-Saud, Air Force, Saudi Arabia (IDMC 07-2)

LTC Emad Aziz, Egyptian Air Defense (IDMC 07-1)

LTC Afërdita Blaka, Albanian Army (IDMC 07-1)

Col Marcelo El Nayar, Army, Argentina (SIDMC 07, MIDMC 05-13)

Capt Zahari Jamian, Malaysian Navy (SIDMC 07)

RADM Leif Nylander, Swedish Navy (SIDMC 07)

RADM Juha Rannikko, Finnish Navy (SIDMC 07, IDMC 99-1)

Col Ernesto Pellizzaro, Air Force, Argentina (SIDMC 07)

Mr. David Stanton, USAF AFSOC/FMJO (DRMC 07-3)

Mr. Janko Steh, Slovenian MoD (SIDMC 07, IDMC 97-1)

Col Yuriy Tsurko of the MoD General Staff, Ukraine (IDMC 07-2)

Class Notes 2006

LTC Salvador Allende de las Moras from the Spanish Air Force (IDMC 06-2) wrote that he is at his new post at an air base thirty minutes from Brussels. His family remains in Madrid and he commutes to see them on the weekends.

We are happy to have received greetings from:

Col Oscar Martinez Conti, Army, Argentina (SIDMC 06).

LTC Dombel Luz, Angolan Army (IDMC 06-2).

Col Enrique Tonazzi Dieterich, Joint Deputy Chief of Staff for Intelligence, Argentine Armed Forces Joint Staff (IDMC 06-2).

Col. Vasil Totev, Bulgarian Air Force (IDMC 06-1).

Class Notes 2005

LTC Dragan Zmajevic, Army Bosnia and Herzegovina (IDMC 05-2) sends DRMI his greetings.

Class Notes 2004 and before

Major General Grant Cavenagh, of the Australian Army (SIDMC 04), sent DRMI his greetings and wrote that he became the Commander Joint Logistics for the Australian Defence Force and Strategic J4 since the start of 2007. He works "pretty closely with my US Strat J4 colleague, GEN Chris Christianson."

Capt Haroon Kalimullah (IDMC 03-1) left the Bangladesh Navy in October and immigrated to the United States.

Ms. Faten Kubba, MoD of Iraq (IDMC 03-1) has been in correspondence with DRMI.

Major General D.A. Antonio Pilotto, Italian Air Force (SIDMC 04), writes, "I was promoted two years ago at 2 star general and now I am the Head of General Office of the Italian Air Force Staff for Airspace and Meteorology."

Curriculum Development, Teaching News and Service

Dr Diana Angelis teaches NPS course on engineering economics via distance learning

Dr. Diana Angelis taught Engineering Economics and Cost Estimation for the department of Systems Engineering during the fall semester.

This distance learning course is offered via video teleconferencing to participants around the country and the globe. The fall semester in-

cluded students from California, Virginia, Florida, Michigan, North Carolina and Baghdad.



The course is an introduction to the cost aspects of systems engineering. It explores cost from a decision making perspective. It examines how cost is used to select alternatives and how the cost of systems can be measured. Concepts covered include economic analysis, cost behavior, cost allocation, system cost, life-cycle costs, cost over time, cost estimating techniques, cost uncertainty, and risk management. The use of cost concepts in defense problems is emphasized.

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Staff and Faculty News

Passing of former DRMI and NPS professor, Captain Alexander W. Rilling

A former member of our faculty, Captain Alexander Rilling, died of Parkinson's Dementia December 18, 2007. The following is from the Monterey Herald, 1/3/2008.

CARMEL - Alexander W. Rilling, age 78, a retired Navy Captain and 35-year resident, died December 18, 2007 from Parkinson's Dementia. Captain Rilling was born in Elizabeth, New Jersey on October 27, 1929. Capt. Rilling earned a Bachelor of Science degree in Management/Aeronautical Engineering at Rensselaer Polytechnic Institute, Troy, NY in 1951; a Master of Science degree in Management at the Naval Postgraduate School in 1962; and a Ph.D. in Educational Administration at the University of Southern California in 1972.

He served on active duty in the U.S. Navy from 1951 through 1974. His service included numerous tours at sea in both the Atlantic and the Pacific; at the Navy Department in Washington, D.C.; on the faculty of the Naval Academy at Annapolis, MD; and working with foreign governments in the Military Assistance Command, Vietnam. Captain Rilling's last three tours at sea were in command of ships, the last being a destroyer, the USS Everett F. Larson, which saw extensive service in the Vietnam conflict. He was also a graduate of the Air War College at Maxwell AFB, Alabama. His service awards included: the Navy Commendation Medal, China

Service Medal, Navy Occupation Service Medal (Europe), Vietnam Service Medal, Vietnam Campaign Medal, and RVN Cross of Gallantry. From 1974 through 1990, Dr. Rilling was a civilian faculty member at the Naval Postgraduate School in Monterey.

Conference Presentations, Research and Publications



Dr. Eva Regnier's paper "Public Evacuation Decisions and Hurricane Track Uncertainty" was a finalist in the Institute for Operations Research and the Management Sciences' Junior Faculty Interest Group paper competition. A version of this paper will appear in Management Science early in 2008.

2008.

Publications

Airola, J. (2007). The use of remittance income in Mexico. *International Migration Review*, 41(4), 850-859.

Kinstler, D. P., R.W. Johnson, A. Richter, K. Kocher. (2008). Navy Nurse Corps Manpower Management Model. In press. *Journal of Health Organization and Management*.

Mehay, S., & Webb, N.J. (2007). Workplace drug abuse programs: Does 'Zero Tolerance' work? *Applied Economics*. 39:2743-2751. Taylor and Francis.

Richter, A. (2008). Assessing the Impact of Global Price Interdependencies. In press. *PharmacoEconomics*.

New Insights (Cont. from page 1)

should be produced within the organization ("make") and which should be acquired outside ("buy")?

In business, two costs typically drive a firm's "make-or-buy" decisions: production costs, and the costs of managing transactions or "transaction costs." Conventional economic analysis focuses on production costs (input costs, learning curves, economies of scale and scope, etc.).

TCE emphasizes transaction costs (search and information costs, decision and contracting costs, monitoring and enforcement costs, etc.).

Transaction costs are especially significant, but not always measured, in the government's defense acquisition systems. For instance, DoD employs an acquisition workforce of more than 100,000 people, and the Defense Contract Management Agency (DCMA) alone is a billion dollar organization made up of over 10,000 civilians and 500 military, whose singular responsibility is to help manage and coordinate defense contracts valued at nearly a trillion dollars. According to TCE, where the performance of a product would be roughly the same, the decision of whether to in-source or out-source ("make-or-buy") involves choosing the option that minimizes the sum of production and transaction costs.

The "hold-up" problem

Another pioneer in the TCE literature is Oliver Williamson. One of his fundamental insights is the "hold-up" problem. In other words, after a contractor wins an initial competition, the government may be at risk later of getting (performance, price, or schedule) held up by that supplier.

Transactions between government and industry can generate substantial gains for both parties. In DoD, the gains from outsourcing are expected to take the form of better performance, faster schedules, and cheaper costs. TCE recognizes, however, that a winning supplier can lock in the government by investing in productive "specific assets" that have the potential to increase performance, speed schedules or lower costs. Ex-ante, this looks good for the government, but ex-post it can lead to a bilateral monopoly relationship.

The problem is that initially advantageous investments in "specific assets" can make it prohibitively costly for other companies to compete in subsequent re-bidding of the contract. The government is then in a position where it can, for example, be "held up" by the contractor for minor modifications in the original contract. On a trip across the country I once sat next to a defense contractor who confided "I make my money on change orders."

Since most complex and uncertain contracts are incomplete-i.e. cannot specify all possible contingencies (or future conditions)-many defense contracting relationships involve extra transaction costs such as measurement, monitoring, and re-negotiation costs that can quickly overwhelm initial production cost advantages. Extra transaction costs required to govern an acquisition can overwhelm any production cost savings. In this case, "in-sourcing is 'in' and out-sourcing is 'out'."

While TCE recognizes the potential gains from outsourcing or joint ventures such as public-private partnerships, it also acknowledges the dark side - motivation. TCE predicts parties involved in a transaction can benefit from cooperative agreements, but may have conflicting objectives (e.g. DoD - maximizes capabilities subject to a budget constraint; defense industry - maximizes profits). As a consequence, parties in a transaction do not always have the motivation to follow through on agreements - particularly when specific assets or investments are involved, and information is imperfect (incomplete and uncertain), or asymmetric (one party has an information advantage over the other). The ultimate outcome depends on specific characteristics of the transaction and on the incentive structures that govern the parties involved.

Conclusion

Viewing defense transactions through the lens of TCE would enrich defense procurement practices. Where there is significant scope for opportunistic behavior, contracts should pay special attention to the use of additional mechanisms to govern external relationships. TCE's primary insight is that the choice of optimal governance mechanism (contracts, organizations, monitoring, incentives, etc.) depends on key characteristics of the transaction ("asset specificity," "uncertainty," "complexity," and "frequency"). According to TCE, the dual focus of any "make-or-buy" (in-source or out-source) evaluation should be: a) to identify key characteristics of the transaction, and b) to evaluate the costs and consequences of alternative contracts, organizational structures and mechanisms available to govern those transactions. The challenge is to design contracts, incentives, monitoring and enforcement procedures, and other mechanisms (property rights, reputation, bonding, warranties, etc.) that align incentives, allowing credible commit-

ments ex-ante and promoting mutual compliance ex-post.

If you would like to learn more, please go to our website <http://www.nps.navy.mil/drmi> and look up Melese & Franck (2005) "A New Guide to Government's 'Make-or-Buy?' Decisions." Alternatively, see Melese, Franck, Angelis, and Dillard (2007) "Applying Insights from TCE to Improve Cost Estimates for Public Sector Purchases" in the latest issue of the International Public Management Journal. If you are interested in a course that applies TCE, consider taking our new DRMI course entitled "Streamlining government through outsourcing, privatization and public-private partnerships." The next one is scheduled the third week in May 2008:

Streamlining government through outsourcing, privatization and public-private partnerships (MASL P162011)

Course overview: The challenge of streamlining government to become more efficient and effective has been answered by looking to the private sector. Countries around the world find themselves increasingly relying on the private sector in three ways: 1) To provide weapons and sup-

port services (Outsourcing), 2) To raise revenues by selling excess property and facilities no longer needed (Privatization), and when budgets are tight 3) To solicit private sector investment in defense projects and operations (Public-Private-Partnerships). This one-week "Streamlining Government" course explores these three alternatives. It offers participants an overview of the opportunities and challenges that face every Ministry of Defense (MoD): To "make-or-buy" defense? Should your MoD become more involved in defense business (make), or should it turn more defense business over to the private sector (buy)? The course weaves economic decision-making and contract theory together with U.S. and international defense examples to offer participants an overview of the current state of knowledge and experience.

DRMI Brochure

The 2008 Defense Resources Management Course brochure is now available. If you would like copies, please contact the Admin Office at 831-656-2104 (DSN 756) or send e-mail to DrmiAdmin@nps.navy.mil

Future Mobile Courses

2008

Jan Iraq Survey
Feb Sierra Leone 4-15 Feb
Mar Colombia 3-14 March
Apr Honduras 14-18 Apr
May Thailand
Jun Malaysia 2-13 June
Aug Nigeria 28 July-8 August
Aug Guatemala
Sep Argentina 8-19 September

Future Resident Courses

Calendar Year 2008

Dates	Course Name	Number	Length
07 JAN – 01 FEB	Defense Resources Management Course	DRMC 08-1	4
04 FEB – 15 FEB	Multi-Criteria Decision Making	MCDM 08-1	2
04 FEB – 16 APR	International Defense Management Course	IDMC 08-1	11
21 APR – 25 APR	Financial Integrity, Accountability and Transparency	FIAT 08-1	1
21 APR – 15 MAY	Defense Resources Management Course	DRMC 08-2	4
19 MAY – 23 MAY	Streamlining Government through Outsourcing, Privatization and Public/Private Partnerships	SGOP 08-1	1
19 MAY – 13 JUN	Defense Resources Management Course	DRMC 08-3	4
23 JUN – 18 JUL	39 th Annual Senior International Defense Management Course	SIDMC 08	4
21 JUL – 14 AUG	Defense Resources Management Course	DRMC 08-4	4
04 AUG – 15 AUG	Base Realignment, Closure and Economic Redevelopment	BRCER 08-1	2
18 AUG – 12 SEP	Defense Resources Management Course	DRMC 08-5	4
01 SEP – 12 SEP	Multi-Criteria Decision Making	MCDM 08-2	2
15 SEP – 24 SEP	Budget Preparation, Execution and Accountability	BPEA 08-1	1.3
22 SEP – 05 DEC	International Defense Management Course*	IDMC 08-2	11

* This course convenes in one fiscal year and continues into the next fiscal year.

For additional information on any of our resident courses please contact Mary Cabanilla at (831) 656-2104 or e-mail DrmiAdmin@nps.navy.mil



The Defense Resources Management Institute publishes the DRMI Newsletter quarterly. Direct questions regarding content or the submission of proposed articles to the Newsletter Editor, DRMI 64We, 699 Dyer Rd, Monterey, CA 93943.