

Report to Congress



The Department of Defense Report on the Development of a Single Defense Resale System

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Executive Summary

Section 627 of the John S. McCain National Defense Authorization Act for Fiscal Year 2019 (the NDAA for FY 2019) (P.L. 115-232) directed the Secretary of Defense to submit, by January 1, 2019, a report to the Congressional defense committees concerning the Congressionally-directed study to determine the feasibility of consolidating the military resale entities into a single defense resale system (hereinafter referred to as “the Study”). Defense resale operations, which include the exchanges and commissaries, have long been recognized as significant non-pay benefits that are especially important in remote, overseas, and contingency areas, and are beneficial to the Department. Additionally, the Department has the objective of establishing a sustainable business model that would ensure the survival of commissary and exchange benefits for the future.

The potential consolidation of the separate defense resale entities has been examined in 12 studies between 1989 and 2015 that each varied in scope. The overwhelming majority of those studies have recommended some form of consolidation based on the obvious benefits, some of which are outlined in this Report. Other than the consolidation of the four separate Military Service commissary systems into the Defense Commissary Agency in 1991, further consolidation has not occurred.

The Department’s financial due diligence and thorough Business Case Analysis support consolidation of: (1) the Army and Air Force Exchange System (AAFES); (2) the Navy Exchange Service Command (NEXCOM); (3) the Marine Corps Exchange (MCX)¹; and (4) the Defense Commissary Agency (DeCA) (collectively “the defense resale entities”), and found that the benefits from consolidation outweigh the expected costs of consolidation. Among the defense resale entities, there is substantial duplication in management and back-office functions, redundant supply distribution chains, and highly overlapping product lines, particularly among the exchanges. Consolidation would produce benefits such as reducing duplicative costs and creating a more efficient workforce. Should consolidation occur, it could be achieved without any material change to the customer experience or store footprint.

Assuming the enactment of statutory authority to consolidate the defense commissary and exchange systems, the Study envisions an organizational and governance structure that would consist of either a new Defense agency or an existing mission-expanded Defense Agency with a single Director / Chief Executive Officer (CEO) and a single Board of Directors. The Director / CEO and the Board of Directors would oversee the operations of the newly established Defense

¹ Morale, Welfare and Recreation (MWR) affiliated activities which are part of the Marine Corps Community Services organization, along with MCX, will be considered for integration into the consolidated organization during the planning phase when all of the Services’ MWR activities are reviewed for potential inclusion.

resale enterprise, including both resale and non-resale lines of business currently under the purview of the defense resale entities, and would provide consolidated headquarters level leadership and management. The new Defense Agency would also oversee consolidated above-store functions that provide services such as human resources, information technology, marketing, and finance, in order to reduce the existing duplication of effort across the defense resale entities. If the Department established a new Defense agency or expand the mission of an existing Defense Agency, it would not impact negatively either the in-store brand equities of the defense resale entities or the customer experience. For the foreseeable future, patrons of the defense resale entities will continue to shop in stores as they appear today, with no closing of storefronts expected due to the Study. Also for the foreseeable future, any new Defense agency or mission-expanded Defense Agency would continue to finance and manage commissary operations through two chartered Defense Working Capital Fund (DWCF) business activities separate from the non-appropriated fund instrumentality (NAFI) or instrumentalities that finance the exchange system.

The Study concludes that the benefits of consolidating the defense resale entities far outweigh the costs. The analysis shows a projected net savings of approximately \$700M-\$1.3B of combined appropriated and nonappropriated funding over a five-year time span, and a recurring annual savings between \$400M-\$700M thereafter.² Consolidating the defense resale entities would require significant effort and involve risk and meaningful change for each of the organizations. Experience has shown with proper resourcing, effective governance, and robust change management processes, risks can be addressed and mitigated quickly before they become problems. Managing risk effectively will allow the Department to keep its promise to the employees and patrons of the defense resale entities and ensure that commissary and exchange benefits are preserved and enhanced.

Background

As required by section 627 of the NDAA for FY 2019, this Report includes:

1. Details of the internal and external organizational structures of a consolidated defense resale system;
2. Recommendations of the Secretaries of each of the Military Departments regarding the plan to consolidate the defense resale entities;
3. The costs and associated plan for the merger of technologies or implementation of new technology from a third-party provider to standardize financial management and accounting processes of a consolidated defense resale system;

² To achieve the patron savings directed by Congress, the defense commissary system will continue to require a substantial annual appropriation to offset operating costs, even if subsequently converted to a non-appropriated fund instrumentality. Furthermore, unless and until the conversion of commissary operations from a DWCF-chartered business activity financed under section 2208 of title 10, United States Code, into an operation conducted and financed by a NAFI, the new or expanded-mission Defense Agency with cognizance of the consolidated system will be unable to use revenue from exchange activities either to offset or otherwise finance commissary operations. Likewise, the DWCFs that finance commissary operations will not be available to fund exchange operating expenses financed through one or more NAFIs that will operate under the cognizance of the new or mission-expanded existing Defense Agency.

4. Best practices to maximize reductions in costs associated with back-office retail payment processing for a consolidated defense resale system;
5. A timeline for converting the Defense Commissary Agency into a non-appropriated fund instrumentality (NAFI) under section 2484(j) of Title 10, United States Code;
6. A determination whether the business case analysis supports consolidation of the defense resale entities;
7. Recommendations of the Secretary for legislation related to consolidation of the defense resale entities;
8. Other elements the Secretary determines are necessary for a successful evaluation of a consolidation of the defense resale entities.

1. Details of the Internal and External Organizational Structures of a Consolidated Defense Resale System

The defense resale entities operate separately and have significant overlap in their current operations. Assuming the enactment of statutory authority to consolidate the defense commissary and exchange systems, a unified management structure reporting to a single Director / CEO and governed by a single Board of Directors will help eliminate these redundancies; enable consistent and coordinated decision-making; represent the interests of the Military Departments; and create a sustainable business model that will preserve the benefit and dividends for the future. This would be further enabled either through the establishment of a new Defense agency or using a mission-expanded existing Defense Agency to manage the consolidated defense resale enterprise, which will incorporate, take cognizance over, and optimally ultimately consolidate the four separate entities that comprise today's defense world-wide systems of commissary and exchange stores.

The above-store functions of the resale organizations (e.g., human resources, information technology (IT), finance, merchandising, and procurement) will be consolidated under a single organization administered by a Chief Administrative Officer (CAO) responsible to the Director / CEO for managing the transition of these functions from the defense resale entities into the consolidated defense resale enterprise. This transition will not occur in a single phase. A six- to nine-month planning and data normalization period has been built into the early phases of the consolidation effort to conduct detailed road mapping and planning. The transition will be scheduled in phases to ensure continuity of business.

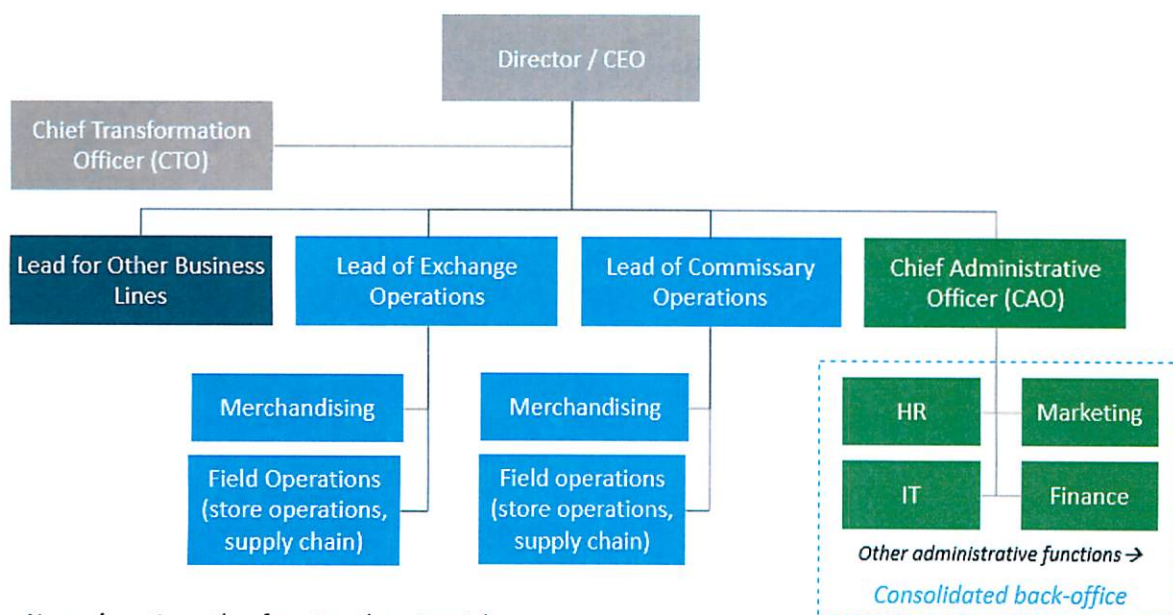
There is enough differentiation between the business model of grocery retail and that of the exchanges to justify separate operational structures, each with its own lead, to support functions such as resale procurement and field operations, which primarily include supply chain and store operations.

A "Lead for Other Business Lines" is also necessary, as the exchanges each operate several distinct business lines in addition to their core resale functions, which include OCONUS bakeries, school lunch programs, uniform management, ship stores, and, in the case of Marine Corps Community Services, Morale, Welfare, and Recreation (MWR) operations. None of these

Other Business Lines operations will be operationally impacted by consolidation, but the reporting lines will need to be modified to account for the new organization.

A Chief Transformation Officer (CTO) will guide the organization through the transition process in the near term. This individual will report to the Director / CEO and will have a wide range of responsibilities focused on establishing an integrated and well-functioning enterprise.

Exhibit 1 – Recommended organizational design



To enable and accommodate consolidation of the defense resale entities, the Defense Agency Director / CEO, reporting directly to the Under Secretary Defense for Personnel and Readiness, resale enterprise-wide operations at initial operating capability, and reporting oversight of the defense resale entities, which will allow the organizations to focus on not only the long-term transformation, but also to pursue early execution against short-term drivers of value, such as merchandising and indirect procurement synergies. None of these changes will impact the Service-specific brand equities experienced by customers in stores, and will not infringe upon the authority of the Military Department Secretaries to meet their mission requirements.

A single Board of Directors will be established providing strategic guidance and advice to the Director / CEO regarding prudent operation and assisting in the overall supervision of the enterprise. It will also ensure the enterprise is responsive to priorities of the Service secretaries in support of their title 10 mission requirements. The existing boards of the defense resale entities will continue to operate in the near term until their functions are assumed by the new Board of Directors. The new Board will be focused on the most strategic priorities of the combined organization, including:

- Recommending the level of benefit desired
- Setting and maintaining the level and allocation of MWR dividend
- Assessing the amount of appropriated funds (APF) required for operations
- Making hiring decisions for key executive personnel
- Approving annual plans, such as operational and budgetary strategy, and major investments
- Engaging with management on the overall strategy and priorities of the organization

The Board may form subcommittees in order to address the specific needs of each of the Military Services, and particularly to ensure the benefit-based mission of the consolidated organization is not lost.

Because section 627(c) of the NDAA for FY2019 prohibits the expenditure of funds to implement consolidation, many of the specific execution efforts outlined in the Study have not yet begun. In the interim, the Department has directed that the task force ensure all planning tasks necessary to achieve initial operating capability of a new or mission-expanded existing Defense Agency, with name to be determined, are completed by September 30, 2019.

2. Recommendations of the Secretaries of each of the Military Departments Regarding the Plan to Consolidate the Military Resale Entities

The Department has consulted with the Military Departments, which agreed with consolidation.

3. The Costs and Associated Plan for the Merger of Technologies or Implementation of New Technology from a Third Party Provider to Standardize Financial Management and Accounting Processes of a Consolidated Defense Resale System

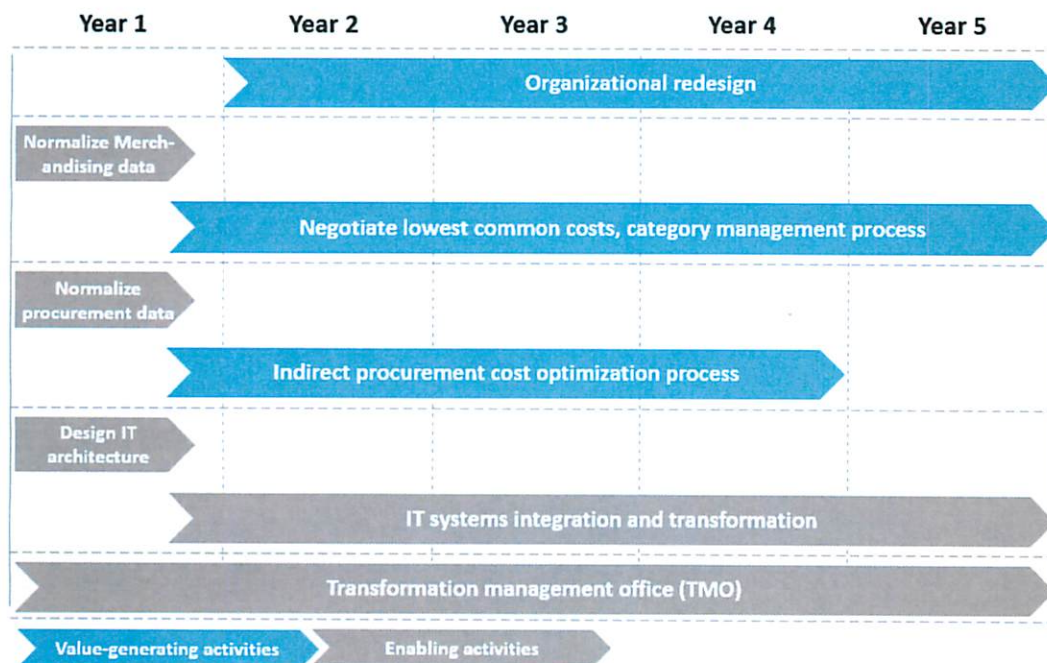
A strong, unified technology backbone is required for long-term sustainment of consolidation synergies. This includes not only a standardized financial management system for the exchange system financed with non-appropriated funds and, eventually, for the commissary system following closure of the DWCF business activities and their conversion or integration into a NAFI, but also for several other critical systems, including merchandising and transportation management systems. IT integration will be challenging and will involve significant change for the organizations, but it is critical for the success and competitiveness of the consolidated resale enterprise.

Many of the risks associated with consolidation can be mitigated by building a robust planning phase into the timeline for IT integration (*Exhibit 2*). The Study recommends a six- to nine-month period at the beginning of the integration where detailed planning can occur, including the development of a unified target architecture which will determine the roadmap for future implementation activities. The organizations will use this time to focus on defining and

standardizing requirements for the systems most essential to the business, and to devise clear plans to address potential issues that may arise during the implementation process.

This period will also be used to further refine cost estimates for full integration. Using the best information currently available, the consolidation of the systems most critical to the business is estimated to cost \$300M-\$400M over five years, and is less than a single year of recurring annual savings. As a point of comparison, this timeline is considerably longer than commercial mergers of comparable scale and complexity. Of this, approximately \$100M is estimated as the cost of a consolidated financial management system.

Exhibit 2 – Implementation timeline



Given the needs of the business and best practices observed in commercial mergers, the financial management systems have been tentatively planned for consolidation in Year 3 and Year 4. Given the high level of interconnectivity between the systems, consolidation of financial management systems will likely be simpler if it is sequenced after other major systems. Additional planning and architecture design for the financial management systems will occur during the period prior to consolidation of the financial management systems. Unified financial reporting can be achieved in the interim by creating a common chart of accounts and mapping a data reporting layer over the four distinct systems operated by the resale entities. This is common practice in commercial mergers.

In the near term, existing financial management processes will continue exactly as they do today, including transactional accounting and accounts payable. Lessons learned from the integration of the commissary systems indicate a carefully phased approach, especially concerning financial management, is prudent to ensure continuity of internal and external business operations.

4. Best Practices to Maximize Reductions in Costs Associated with Back-Office Retail Payment Processing for a Consolidated Defense Resale System

Payment processing is one of many areas where consolidation will lead to cost reductions, primarily due to improved management through increased scale. A consolidated organization can more effectively manage the combined volume of payments by allowing a single finance team, supported by a consolidated financial management system, to function as a shared service center supporting the full organization. In contrast, today four finance teams each serve their individual organizations, leading to significant duplication of effort across defense resale.

Today, the defense resale entities contract with a highly overlapping set of vendors, especially in the procurement of goods for resale, where a substantial portion of the top vendors is shared among two or more of the resale entities, and is true of goods and services not for resale as well. For example, nine of the top ten goods for resale vendors are common to two or more of the organizations and make up over \$1B of spending. Rather than managing multiple points of contact and transmitting funds through multiple payment systems which all interface with the same vendor, relationships will be streamlined eventually into a single point of contact and a single payment system.

Industry best practice in consolidation scenarios is also to pursue savings through spend rationalization, which concentrates contracts among fewer vendors to achieve lower costs. Since the total number of external vendors will decrease, payment processing costs will also decrease as the number of vendors under management decreases. Finally, consolidation will also lead to reductions in costs associated with the processing of retail transactions for customers at the point of sale, including credit and debit card fees. The increased scale of transaction volume for the consolidated entity will facilitate the process of negotiating for rate reductions with credit and debit card processing vendors.

To ensure continuity of business in the near term, daily transactional accounting and finance activities, including payments to external vendors and employees, will continue as-is until the consolidation of financial management systems is completed. As noted in Section 3, this carefully phased approach will include a planning period of six- to nine-months to develop a fully detailed consolidation road map for IT systems, including decision-making around how and when to best pursue payment processing integration. All changes to financial processes and business practices will take place gradually, and only after careful implementation planning with close oversight by the Transformation Management Office.

5. A Timeline for Converting the Defense Commissary Agency into a Nonappropriated Fund Instrumentality under Section 2484(j) of title 10, United States Code

Pursuant to 10 U.S.C. 2484(j), the Secretary of Defense may convert the defense commissary system from one financed and operated under DWCF business activity charters into a NAFI if certain conditions are met. Currently, commissary operations are financed using DWCFs derived from commissary sales revenue and from annual appropriations into the DWCF's corpus. The timeline for conversion would depend on the new or the existing mission-

expanded Defense Agency's ability to migrate financial management and other systems that support its business practices, as well as its ability to transition personnel and commissary operations from appropriated funds (APF) to NAF financing.

Transition of financial management and other systems has also been addressed in Section 3 of this Report, and is projected to be complete by Year 4 of consolidation activities. By Year 3, approximately \$80M in annual recurring expenses that are currently being paid by non-Department of Defense federal agencies, will be absorbed by the consolidated organization; and will have to be budgeted by the Department if the title 10, chapter 147 mandated savings level for commissary patrons is to be maintained. Significant effort will be required early in the process to develop a common chart of accounts and set of financial processes that will be used by the consolidated NAF organization, and subsequently for commissary operations after the eventual closure of the two DWCF business activities that finance commissary operations and conversion or integration of commissary operations into a NAFI. Transition of personnel, on the other hand, is projected to occur over a longer period of time.

Section 2484(j) authorizes the Secretary to identify employees in the defense commissary system who are paid with APF who may be converted to NAF employees if the commissary system is converted into a NAF entity or instrumentality. Section 2484(j) anticipates the entire commissary system being converted into a NAF entity or instrumentality³ in order to convert personnel. An employee who does not consent to conversion to NAF may not be removed from the position because of the failure to provide such consent. If the commissary system were converted into a NAFI, the DoD would request Operation & Maintenance appropriations for the new or existing mission-expanded Defense Agency to fund compensation costs for commissary system employees who decline to convert into a NAF personnel system. Over time, the workforce composition will adjust to a higher proportion of NAF personnel, resulting in material savings in personnel costs, which will be realized as the composition of the workforce adjusts. The value of these savings has not been included in any return on investment calculation, and would be in addition to any savings estimates presented in the Study. However, in order to maintain the Congressionally-mandated savings benefit for authorized patrons, substantial APF funding will be required indefinitely to support commissary operations.

Section 2487(c) of title 10 authorizes the establishment of common businesses processes, practices, and systems (1) to exploit synergies between the defense commissary system and the exchange system; and (2) to optimize the operations of the defense retail systems as a whole and the benefits provided by the commissaries and exchanges. The defense resale entities are authorized to enter into contracts or other agreements for products or services that are shared by the defense commissary and exchange systems, as well as for the acquisition of supplies, resale goods, and services on behalf of both the defense commissary system and the exchange system. This authority enables the defense resale entities to coordinate and financially consolidate execution of many of their operations in order to realize savings before or without converting commissary operations into a NAF entity or instrumentality.

³ Conversion would necessitate closure of both DWCF activities that finance the commissary system.

6. A Determination Whether the Business Case Analysis Supports Consolidation of the Military Resale Entities

After conducting a thorough, data-driven analysis, the Study and this Report conclude the benefits of consolidation far outweigh the costs. As noted previously, consolidation is projected to deliver \$700M-\$1.3B in cumulative net savings over the first five years, and \$400M-\$700M in recurring annual net savings across both NAF and APF (*Exhibit 3*). Expected synergies have been identified in reduction of costs for resale procurement, reduction of costs for non-resale procurement, and reduction in redundant personnel. All of these savings can be achieved through leveraging the increased scale of the consolidated organization.

The expected sequencing of these savings incorporates all projected implementation costs, and has been phased according to a realistic timeline that allows for a significant period of planning and road-mapping at the beginning of consolidation activities. This planning period will require an upfront investment before savings are achieved. The investment required is less than \$75M in Year 1, and could be recovered with synergies achieved through operating activities by Year 2 of consolidated operations. Exhibit 2 provides a more detailed view of projected savings and costs over a five-year consolidation timeframe.

Exhibit 3: High-level view of sequencing of expected savings, costs, and net benefits⁴

<i>\$ millions</i>	Year 1	Year 2	Year 3	Year 4	Year 5	5 Year Total	Recurring Annual
Exchange Synergies	30 - 47	104 - 157	203 - 295	277 - 402	304 - 446	917 - 1,347	304 - 446
DeCA Synergies	12 - 18	44 - 66	100 - 155	150 - 252	169 - 308	474 - 798	169 - 308
Total Synergies	42 - 65	147 - 223	303 - 450	427 - 654	474 - 754	1,392 - 2,145	474 - 754
One-Time Costs	(59) - (73)	(122) - (147)	(109) - (129)	(124) - (156)	(44) - (65)	(457) - (570)	
Recurring Costs			(80)	(80)	(80)	(240)	(80)
Net Benefit	(17) - (8)	25 - 75	114 - 241	223 - 418	350 - 609	695 - 1,335	394 - 674

7. Recommendations of the Secretary for Legislation Related to Consolidation of the Military Resale Entities

The Department, in coordination with other Federal agencies, will consider the submission to Congress of a legislative proposal for inclusion in the NDAA for FY20 related to the consolidation of the defense resale entities.

⁴ Throughout this document, savings are attributed to either "Exchange" or "DeCA". These can be assumed to refer to NAF and APF savings, respectively, based on their current cost structures, but final discretion regarding the source of savings would rest with the Board of Directors, DoD, and Congress. Costs have not been separated into APF and NAF categories, as costs are shared across the combined organization and are difficult to cleanly separate.

8. Other Elements the Secretary Determines are Necessary for a Successful Evaluation of a Consolidation of the Military Resale Entities

None required.