Welcome

Predicting the Future:

Federal Contracting in an Election Year

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DOING BUSINESS IN A BUDGET CRISIS

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THE CURRENT STATE OF FEDERAL ACQUISITION

- Acquisition System "Broken"; "A National Disgrace"
- Weapon system failures and overruns; wartime scandals
- In transition from relaxed 1990's reforms to stricter regime – return to competition, fixed prices, and oversight; in-sourcing but acquisition workforce still inadequate
- Distrust of contractors; DCAA audits and withholds, IG investigations and Influence, Qui Tam Actions and loose FCA definitions; aggressive S&D actions, and FAPIIS
- A "Global War Against Contractors"

THE CURRENT STATE OF FEDERAL ACQUISITION

And now, with the acquisition system already stressed, the Government and its contractors must face this new fact of life:

THERE IS ALSO NOT ENOUGH MONEY!

AND SOON THERE MAY BE EVEN LESS!

THE BUDGET CRISIS

- FY 2011 Arithmetic: U.S. Spending = $3,598TR

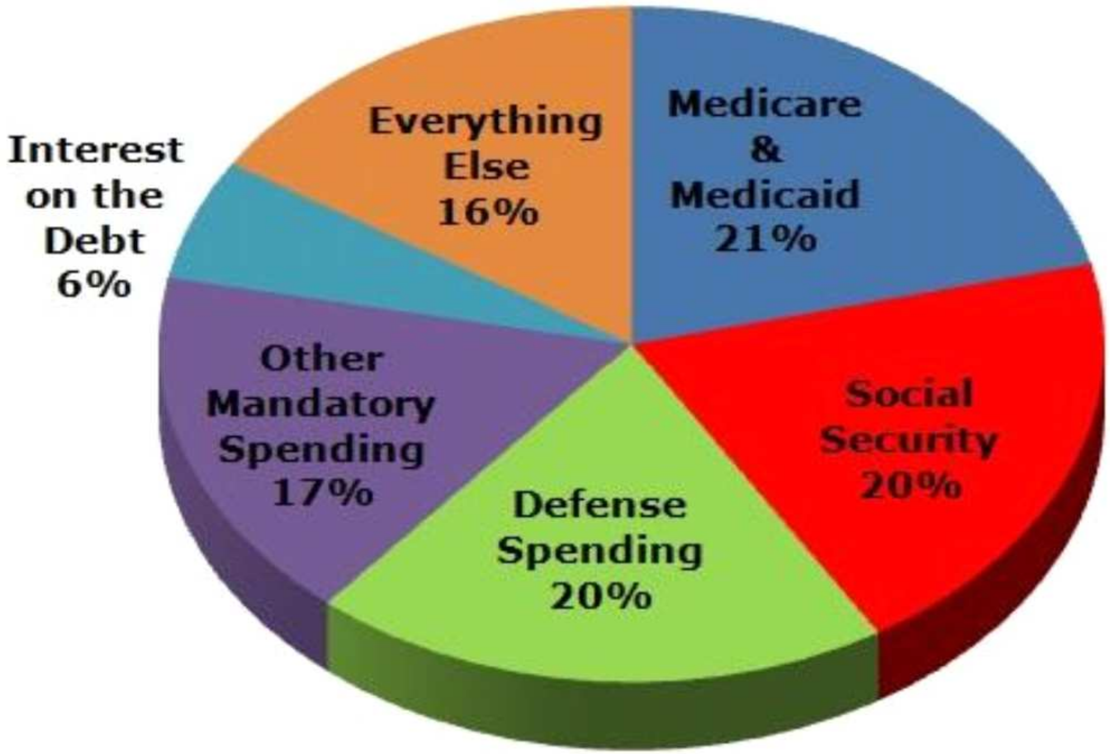
  U.S. Revenues = $2,303TR

  Deficit = $1,295TR
- Of the FY 2011 Spending, 62% or $2,032TR consists of mandatory entitlements and debt costs; 38% is discretionary spending; 20% defense
- Total U.S. debt as of January, 2012 approached $16TR

THE BUDGET CRISIS

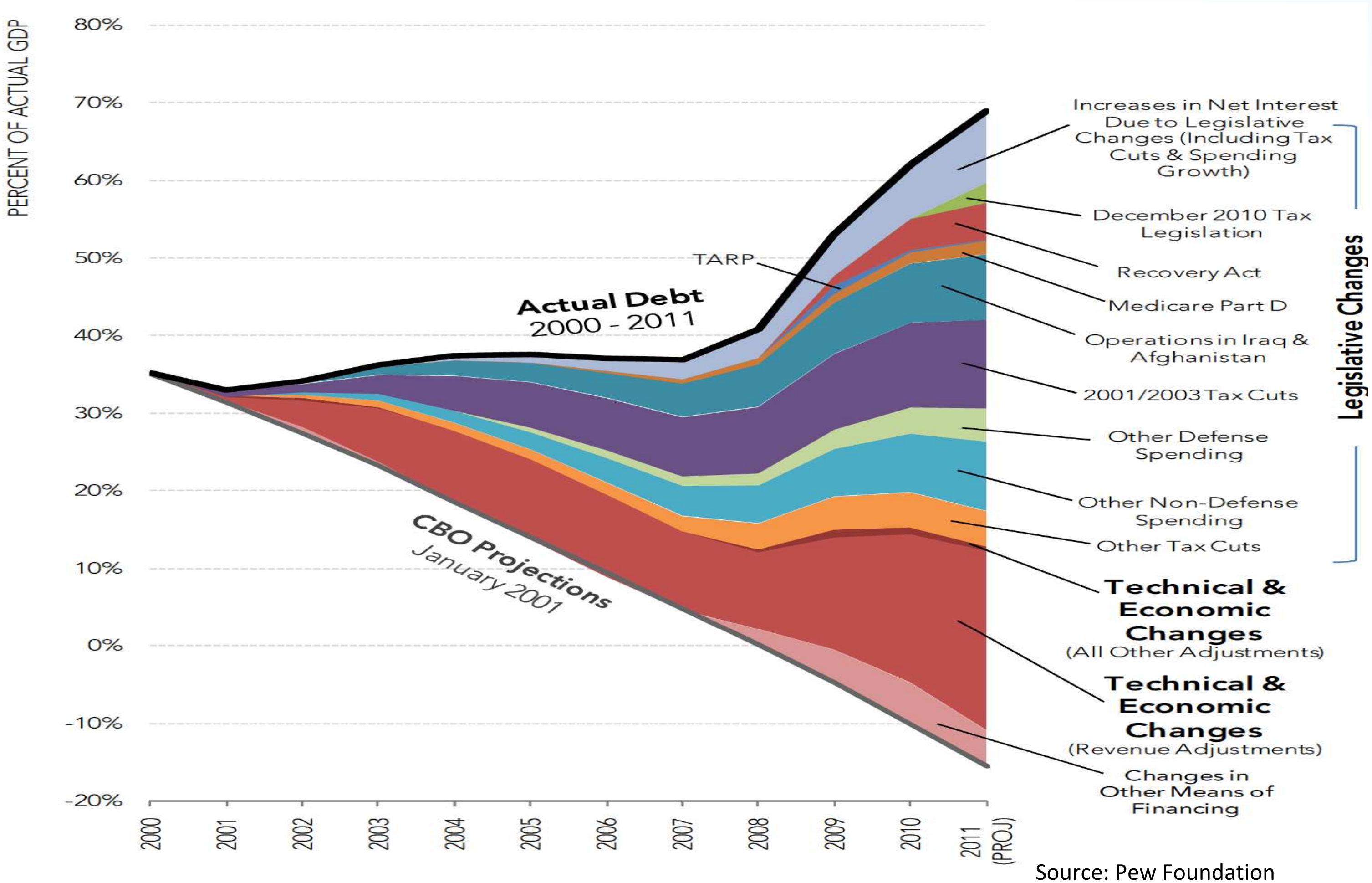
- Long-Term Deficit Growth: Looming "Baby Boomer" Impacts = Uncontrolled, Unsustainable Entitlement Growth

2010 Budget Shows Few Areas to Cut



Source: Bipartisan Policy Center

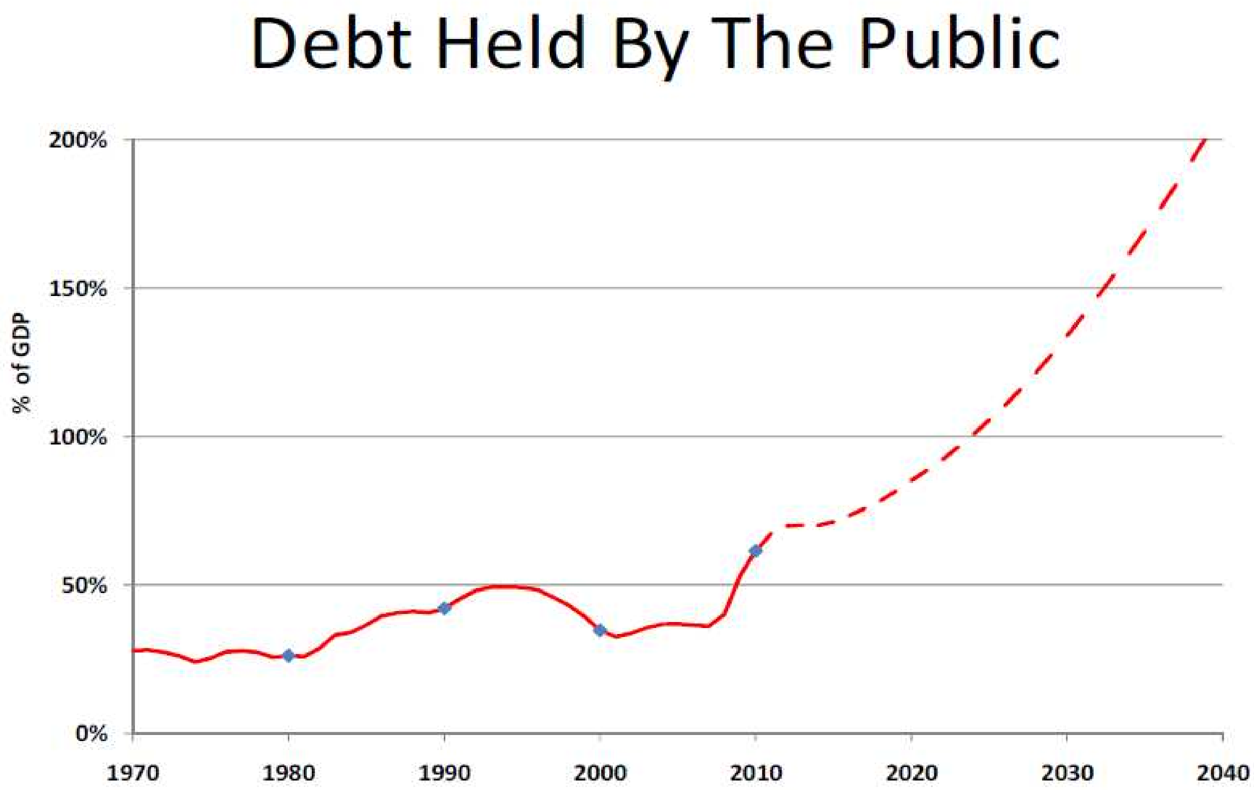
No single thing can be blamed - policy choices, demographics, and the economy all played a part



Source: Pew Foundation

Federal Debt Has Exploded Since 2001

and if unchecked will crowd out the economy



Source: CBO's "Alternative Fiscal Scenario" constructed from the August 2010 Budget and Economic Outlook, additionally assuming that troops in Iraq and Afghanistan are reduced to 30,000 by 2013.

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SHORT TERM BUDGET "SOLUTIONS"

- The Political Impasse – No "Grand Bargain"
- Continuing Resolutions on FY Budgets
- The Budget Control Act of 2011 (P.L. 112-25)
- Threatened sequestration of 1.2 Trillion – A "Catastrophe" but no DoD planning
- DoD planned budget cuts and avoidance proposals
- The post-election poker game, resulting uncertainty and the challenge to acquisition

THE BCA DEBT DEAL

- Cut $917 billion over ten years through statutory caps on discretionary spending for 2012 - 2021
- Sets up a mechanism for at least $1.2–1.5 trillion in additional savings
- Created a Super Committee and a mechanism to fast track its proposals
- Sequestration if $1.2 trillion in savings not reached, with 50% from Defense budget

SEQUESTRATION - BUDGET CONTROL ACT OF 2011

- New sequestration process automatically cuts spending across-the-board IF Super Committee fails to achieve at least $1.2 trillion in deficit reduction
- Spending cuts apply to FY 2013 – FY 2021
- Both mandatory & discretionary programs

If triggered – process entails 4 steps

1. Discretionary spending limits for FYs 2013-2021 divided into security and non-security
2. Reduction amount calculated – equally divided between two categories: Defense and Nondefense
3. Amounts further divided between discretionary and mandatory within each category (excluding certain programs)
4. Reductions achieved through combination of sequestration and downward adjustment of discretionary limits

SEQUESTRATION – WHAT GETS CUT

- Spending cut trigger - Cannot raise any taxes
- Won't Cut: Social Security, veterans' benefits, civilian and military retirement, and all low-income subsidies including Medicaid and the "welfare" programs (food stamps, SSI, etc.) would be exempt from the trigger. Net Interest payments would also be exempt.
- Revises Statutory Limits on Discretionary Spending
  - (1) to redefine the security and nonsecurity categories; and
  - (2) to set annual limits for each of these categories through FY 2021

  Creates firewall to protect 50% Defense 50% NonDefense split
- Will Cut: Defense, all discretionary spending, Medicare, farm subsidies, mandatory housing subsidies, and a few smaller mandatory spending programs

MECHANICS OF SEQUESTRATION

Required Goal: Must cut spending by $1.2 trillion over nine years

1. Subtract Committee work (if any)
2. Subtract interest savings (18% of the total, or $216 billion) = $984 billion of spending cuts
3. Divide by nine, to allocate the spending reductions equally across the nine FY 2013 – FY 2021 = $109 billion per year for each of FY 2013 – FY 2021
4. Divide by two, to allocate the annual spending reductions between defense and nondefense functions

Result: $54 billion Defense / $54 billion Non-Defense

5. Categories are further divided proportionally between discretionary and nonexempt direct spending yielding four amounts of required spending reductions, respectively in:

   (1) defense discretionary appropriations,

   (2) defense direct spending,

   (3) nondefense discretionary appropriations, and

   (4) nondefense direct spending

<u>SEQUESTRATION - AGENCY FLEXIBILITY?</u>

Question: When facing cuts, can affected Departments and Agencies pick and choose amongst their programs?

Answer: Apparently not, the legislative language refers to <u>accounts</u>.

Question: Can Congress?

Answer: Yes, through FY 2014 – FY 2021 Appropriations process

- The required spending reductions are achieved each year (FY 2013 – FY 2021) through a combination of a sequestration process and the downward adjustment of the *revised discretionary spending limits*
  - Specifically, the reductions required are implemented in three parts
    - (1) for discretionary spending for FY 2013, a sequestration of budgetary resources in that year;
    - (2) for discretionary spending for FY 2014 – FY 2021, a downward adjustment of the *revised discretionary spending limits;* and
    - (3) for direct spending, a sequestration of budgetary resources in each year from FY 2013 through FY 2021

DOD'S PLANNED BUDGET CUTS

- DoD FY 2013 plan calls for cutting its budget by $259B through FY 2017 and a total of $487B by 2021
- The FY 2013 reduction of $45B (or $31.8B from BCA Cap enactment) will increase to over $50B in subsequent years; by FY 2021, this will effect an 8.5% reduction
  - Among other savings, DoD plans to cut 80,000 soldiers and 20,000 marines, buy 179 fewer F-35s, cut seven Air Force tactical squadrons, retire seven Navy Cruisers, and reduce the Air Force air lift fleet. Also delay Army Ground Combat Vehicle, reduce purchases of Global Hawk drones, delay the Navy's new ballistic missile submarine, and reduce Air Force support service contractors.

DOD'S PLANNED BUDGET CUTS

- Of the $259B five-year savings:
  - $94B would come from weapons procurement;
  - $60B from O&M; and
  - $17B from R&D

IMPACT ON INDUSTRIAL BASE: INDUSTRY WARNINGS

- "Significant personnel lay-offs, shuttering production facilities, reassessing RTD investments"; "cripple certain defense sectors"
- "Close production lines and lay-off skilled workers"; "loss of technical and scientific talent"
- Supply chain disruption and loss; "push many 2nd and 3rd tier suppliers away from DoD related business"
- Cause investors to put their money elsewhere"; restructuring and divestitures; lowered valuations

IMPACT ON INDUSTRIAL BASE: INDUSTRY WARNINGS

- Industry Appeal for "fundamental changes in the way DoD intersects with industry when it comes to compliance measures, cost and risk sharing and program stability"; "streamlining acquisition processes"; export control reform

AIA-NDIA-PSC Letter to DoD (Nov. 2011)

IMPACT ON THE INDUSTRIAL BASE: DOD MITIGATION EFFORTS AND ASSURANCES

- DoD "committed to maintain the health and productivity of the industrial base"; needs to "adapt its industrial base considerations and actions to the emerging fiscal realism"
- "We do expect some niche firms to face difficulty due to decreased demand" and will "attempt…, if necessary, to mitigate these issues"
- "The vast majority" of the base "act as suppliers"; "companies at any tier, and of any size, may offer critical or hard-to-value products"

IMPACT ON THE INDUSTRIAL BASE: MITIGATION DOD EFFORTS AND ASSURANCES

- "The new Section-by-Section Tier-by-Tier repository of industrial base data" (S2T2) will be "used to manage our investments…to ensure a healthy industrial base for key sectors critical to future capabilities"

Brett B. Lambert

Deputy Ass't Sec. Def.

Manufacturing and Industrial Base Policy

HASC Testimony, November 2011

IMPACT ON THE INDUSTRIAL BASE: MITIGATION DOD EFFORTS AND ASSURANCES

- One of six objectives: "Strengthening the Industrial Base"; a healthy base means a "profitable base, but it also means a lean and efficient base"; "we will ensure critical skills and capabilities…are identified and preserved"

Frank Kendall

OUSD AT&L

October 2011 Memorandum

PROTECTING THE TAXPAYERS' SCARCE FUNDS

- But the Government will also act aggressively to limit expenditure of scarce funding:
  - Program and contract deferral, stretch-out, descoping; in-sourcing; non-exercise of anticipated options or non-issuance of task orders
  - Terminations, and, where possible, for default; Government claims, cost disallowances, and withholds; possible "Do Not Pay" mentality
  - Leveraged negotiations of new terms

PROTECTING THE TAXPAYERS' SCARCE FUNDS

– Low price, technically acceptable competitions
– Fixed price contracting, hybrid contracts, risk allocation clauses, contractor warranties; fee claw-back provisions in cost reimbursement contracts
– Commercial item cost information to assure price reasonableness; cost-based negotiations; hard-line on profits/fees
– Data rights clauses and claims

PROTECTING THE TAXPAYERS' SCARCE FUNDS

- Intense Oversight/scrutiny from Congress, GAO, IGs, and DCAA; early, broad, and aggressive reach of suspension and debarment

SOME GENERAL ADVICE ON HOW CONTRACTORS MIGHT PROTECT THEMSELVES

- Government still largest buyer, but the business impacts of lost or reduced programs on some contractors may be severe, even devastating
- Plan for impact of loss or reduced programs on competitive position (OH spread on reduced business base); do not count on program stability or "anticipated" task orders. Get lean.
- Government actions may also have legal consequences

SOME GENERAL ADVICE ON HOW CONTRACTORS MIGHT PROTECT THEMSELVES

- Government will try to take budget cutting actions regarding existing contracts at minimum cost. For Example: T4D instead of T4C or T4C loss K assertion
- Examine program vulnerabilities (overruns/delays) to find Government causes/legal excuses/basis for the defenses/claims. May be used to defend programs themselves, against cuts – and unfavorable past performance ratings
- Budget cutting may be basis for affirmative breach or changes claims; pricing may account for lost OH absorption

SOME GENERAL ADVICE ON HOW CONTRACTORS MIGHT PROTECT THEMSELVES

- Rigorous compliance with any "notice" provision to the Contracting Officer relating to increased costs (*e.g.*, Limitation of Costs, Limitation of Funds, Changes, etc.)
- Indemnification - increased risk that appropriate funds may be insufficient under the Insurance - Liability to Third Persons clause (FAR 52.228-7)

SOME GENERAL ADVICE ON HOW CONTRACTORS MIGHT PROTECT THEMSELVES

- Increased lobbying activity to preserve contractor’s “wallet share” of smaller procurement budgets:
  - Possible increased scrutiny of lobbying costs (*e.g.*, allowable vs. unallowable, prohibition on use of federal funds for lobbying)

SOME GENERAL ADVICE ON HOW CONTRACTORS MIGHT PROTECT THEMSELVES

- New Competitions: Be ready for protests and assess the fixed price risks.
  - Increased reluctance by GAO/COFC to dislodge awardees with materially lower costs/prices
- A new era of claims and litigation? Maybe. But be vigilant about preserving contract rights (both primes and subs).
  - Account for "cost saving" delays in legal budgets and projected recoveries (*e.g.*, kicking the proverbial can)
- "Read the Contract" and brush up on your "Nash & Cibinic"

SOME GENERAL ADVICE ON HOW CONTRACTORS MIGHT PROTECT THEMSELVES

- And don't forget about compliance, because the "global war against contractors" is not going away