

How Not to Alienate Business Partners: A Framework for Addressing Factors Impacting Retention of Defense Contractors

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INTRODUCTION

The National Security Innovation and Industrial Base (NSIB) is the bedrock upon which American military strength is built.¹ This industrial base draws its strength from the vibrance and resilience of the U.S. economy. In recent years, however, the NSIB has started to detach from the greater U.S. economic base. Specifically, in a departure from most of U.S. history, segments of the domestic economic engine—private industry—are choosing not to work with the federal government in general, and the Department of Defense (DoD) in particular. This decline in the NSIB is occurring precisely when the federal government increasingly relies on commercial technologies. In 2022, DoD's list of 14 critical technology areas vital to national security identified only three that are defense-specific (hypersonics, directed energy, and integrated sensing and cyber). The vast majority of critical technologies on this list are either the result of "existing vibrant commercial sector activity" (Under Secretary of Defense for Research

and Engineering, 2022, p. 4) or emerging technologies being developed exclusively in the private sector or in collaboration with DoD.

Despite this reliance on commercial capabilities, defense acquisition, budget, and business processes continue to become more complex, more heavily regulated, and out of sync with the private sector. The consequences of this trend for U.S. military strength are considerable. The federal government is not leveraging or getting access to some of the most advanced technologies and capabilities the commercial markets have to offer—but many of our competitors and potential adversaries are. Start-ups have access to global capital and markets, innovation is diversifying across borders, and technology development in areas relevant to the military is proliferating. The U.S. failure to leverage commercial industry is a recipe for losing our military, cyber, and intelligence advantages.

But the situation is perhaps even more dire. At the same time the federal government is losing access to leading commercial solutions, those companies that are committed to remaining in the NSIB are hamstrung by statutes and government policies that inhibit innovation and adaptation. Members of the NSIB (such as traditional defense contractors) are at a severe disadvantage when competing with industry for high-skill talent critical to innovation, dedicating resources to R&D,

and staying ahead of the technology and innovation curve.

The United States is already seeing its military advantage in a range of capabilities erode, including in hypersonics, where certain Chinese and Russian capabilities exceed those of the United States (Tucker, 2023). Moreover, China is rapidly eroding U.S. naval overmatch and air superiority in the Indo-Pacific region (Congressional Research Service, 2022).

The United Kingdom recently reexamined their relationship with industry, and in a recently published Defense Command Paper, concluded that they will embark on a new type of relationship based on the premise that "Industry is, and must feel, part of the Defense Enterprise." DoD needs a similar holistic reassessment of its relationship with industry built on an honest assessment of DoD practices, an understanding of the business needs of industry, open channels of communication, and sensible regulations that support national security without excessive bureaucracy.

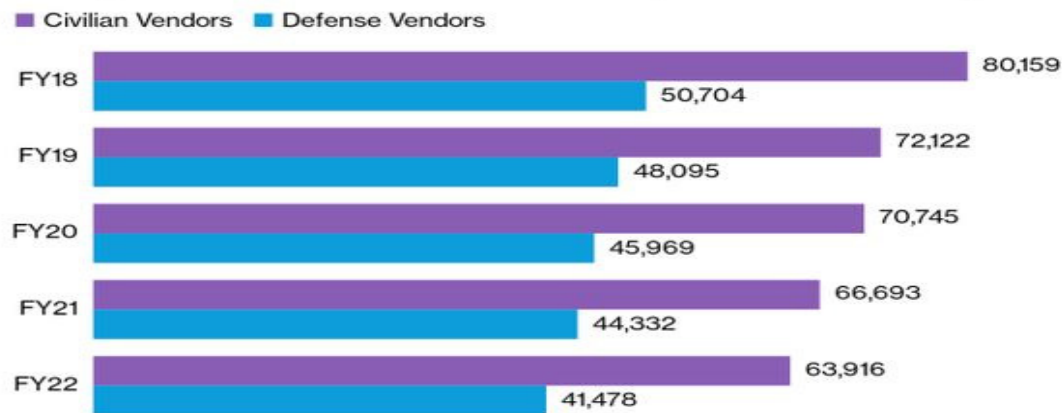
This report asks, and identifies data to answer, four simple questions:

1. Is the NSIB continuing to shrink?
2. Are DoD's efforts to reach out to industry and bring more companies into the NSIB working?
3. What about the acquisition regulations is driving the trend of shrinking the NSIB and hamstringing those companies that remain?

1. We use the term National Security Innovation and Industrial Base because we believe that innovation and industrial strength both matter, and the term defense industrial base does not capture the full gamut of national security. For example, it excludes intelligence services and other agencies that support national security.

Figure 1. Defense Supplier Base Down as Overall Federal Contractor Count Falls (Murphy, 2023)

Defense Supplier Base Down As Overall Federal Contractor Count Falls Pentagon's steady decline leads to 18% drop over last five fiscal years



Source: Bloomberg Government

Notes: Totals represent counts of unique parent companies; parent company counts consist of all identified divisions and subsidiaries. The displayed counts are not additive because many companies perform work for both the Defense Department and civilian agencies.

Bloomberg Government

4. What can be done to make the NSIB a more attractive market for industry to pursue?

Time is running out to prevent the U.S. from falling behind in the race for technological and operational superiority. DoD and Congress must heed the words of Reignier in Henry VI: “Defer no time; delays have dangerous ends.”

THE NSIB IS SHRINKING—BUT THAT IS ONLY THE BEGINNING OF THE STORY

According to publicly available data, the NSIB is shrinking. A 2021 Government Accountability Office (GAO) report found that from FY2011 to FY2020, the number of small businesses receiving DoD contract awards decreased by 43%, even as obligations to small businesses increased by approximately 15% (GAO,

2021). But this is not a small business story—it is an industry-wide story. The same report found that the number of larger businesses receiving contract awards fell by 7.3% annually over the same period, a *more* precipitous decline than the 6% annual decline in the number of small businesses receiving contract awards (GAO, 2021, p. 9).

Not too many years ago, we had five times as many contractors and there was more competition and there was more creativity.

– Representative Ken Calvert

The NSIB continued to shrink in 2022 across both small and larger businesses and across both DoD and govern-

ment-wide contracting. According to a Bloomberg analysis, the number of small and other businesses contracting with DoD slid further in fiscal years 2021 and 2022, with small businesses decreasing by 5% and 7%, and other business decreasing by 1% and 5%, respectively (Nieberg and Murphy, 2023).

A separate Bloomberg analysis reveals a drop in defense contractors of 2,854 vendors from FY2021 to FY2022 (Murphy, 2023), and a similar trend played out in civilian agencies (See figure 1).

Figure 2 depicts data from three different analyses of contractor participation and Figure 3 depicts four different analyses of small business participation in the defense industrial base. While each analysis (published by GAO, CSIS, Bloomberg, NDIA, HigherGov, and a paper presented at the Naval Postgraduate School) is different, they all show a clear downward

The NSIB Is Shrinking—But That is Only the Beginning of the Story

Figure 2. Contractor Participation in the Government Marketplace—Trends

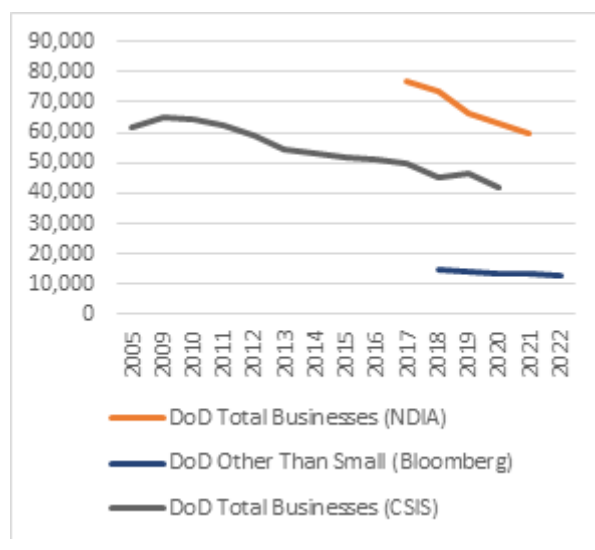
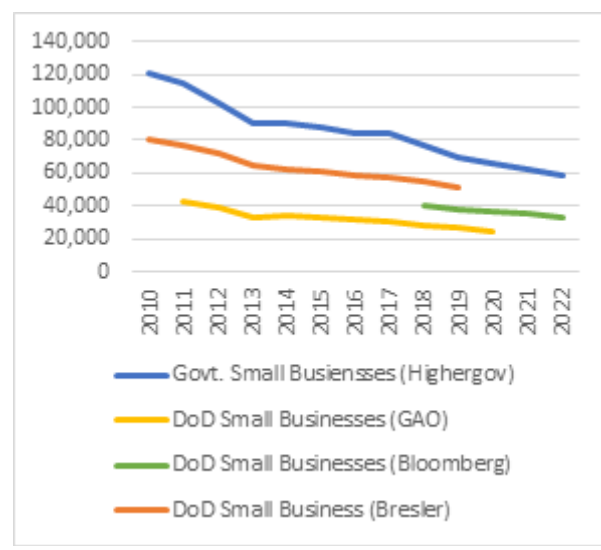


Figure 3. Small Business Participation in the Government Marketplace—Trends



trend in contractor participation in the government marketplace.²

Some analysts have questioned the reliability of the data, suggesting that the decline in the government marketplace is overstated. Even if the NSIB has contracted at a fraction of the pace that the data indicates, alarm bells should be

2. See Appendix A for source data. The various data sources referenced in this report do not match. Such inconsistencies appear to be related to differences in methodology and when analyses were conducted. For example, because FPDS changed its methodology in 2015, CSIS removed from its analysis small contractors included in pre-2015 FPDS data that would not need to be reported under current rules. The Bloomberg data “represent[s] counts of unique parent companies” and consolidates all identified divisions and subsidiaries of a particular entity. In addition, FPDS is a dynamic source that updates data daily, returning slightly different results depending on when the data was run. Despite these inconsistencies, the overall trends are consistent.

ringing. (If the data is wrong, that would raise serious concerns over DoD’s use of data and the reliability of its data systems to inform policy—perhaps the subject of a future paper.)

What is not captured in the data are other ramifications of these trends. For example, some companies have told us that they have made a business decision to be a government subcontractor because they do not want to work directly with the government. Other companies in the defense market told us that they have chosen to forgo competing for certain contracts because of government-unique requirements. Yet other companies have indicated that they do not offer some of their most advanced technologies to the government because of IP protection fears.

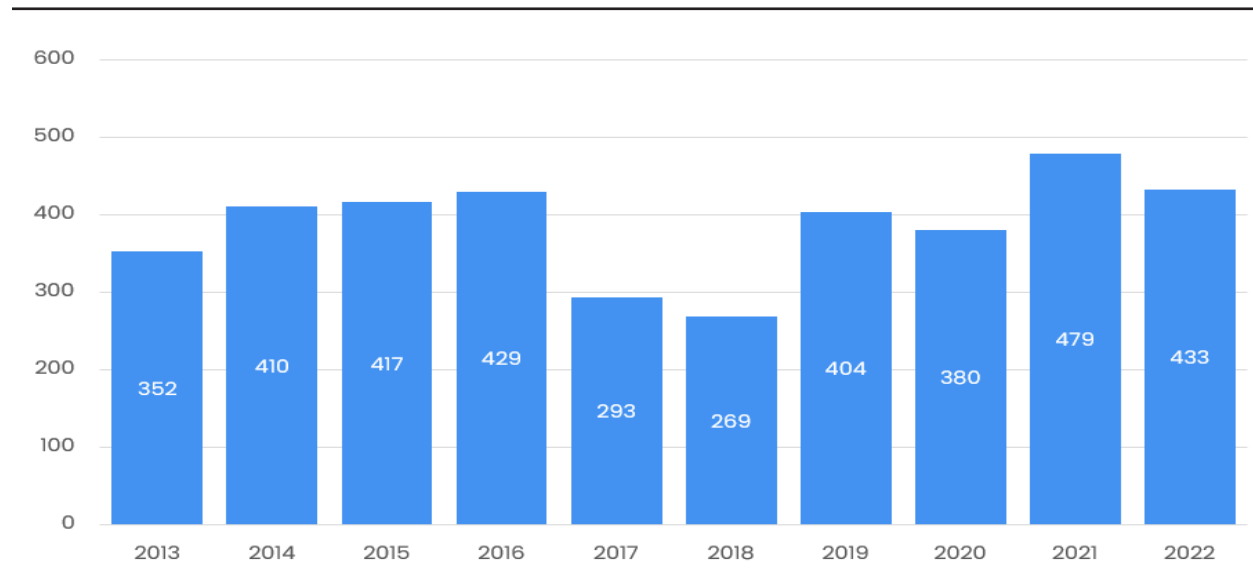
Mergers and Acquisitions

Many analysts, and even DoD’s assessment of the defense industrial base, have

attributed the decline primarily to mergers and acquisitions. (See, for example, the 2022 DoD report *State of Competition in the Defense Industrial Base*). While mergers and acquisitions continue to occur in the defense marketplace, those numbers pale in comparison to the larger trends. Figure 4 reflects the results of a study conducted by HigherGov, which identified 433 mergers and acquisition in the aerospace, defense, and government sector in 2022 (Siken, 2023). Comparing this data to the Bloomberg numbers, this consolidation accounts for approximately 15% of the drop in defense contractors. The other 85% of consolidation would appear to occur for other reasons, including vendors choosing to leave the defense marketplace. To the extent that mergers and acquisitions are a concern, it might be worth exploring to what extent DoD policies are prompting companies to merge or be acquired.

The NSIB Is Shrinking—But That is Only the Beginning of the Story

Figure 4. 10 Year M&A Transaction Volume Trend (Count) (Siken, 2023).



Furthermore, mergers, acquisitions, and takeovers are not unique to the defense sector. They occur in the larger U.S. economy, which nonetheless continues to grow, both in dollars and the number of businesses. According to U.S. data gathered by the Institute for Mergers, Acquisitions, & Alliances for the years 1985–2016, the domestic defense and aerospace industry experienced 4,300 mergers and acquisitions, compared to more than 126,000 announced deals in the greater economy during the same period (3.5% of all M&A activity). When compared to other sectors, the aerospace and defense industry ranked 56 out of a total of 92 industries for the number of mergers and acquisitions conducted. (Institute for Mergers, Acquisitions & Alliances, 2023).

Economically, U.S. GDP grew by 49% from 2011 (\$15.6 T) to 2021 (\$23.3

T), with a significant 10.7% increase (\$3 trillion) from 2020 to 2021 (World Bank, 2023). The number of businesses in the U.S. economy increased by 7% from 2010 to 2019 (Census Bureau, 2021) and the number of applications for new businesses almost doubled from 2011 to 2022, from 2.58 million to 5.1 million filings.

Data from the Small Business Administration showed a net increase of 180,528 businesses from March 2020 to March 2021 (Small Business Administration Office of Advocacy, 2022). The Bureau of Labor Statistics (2023) reported a net increase of 618,391 establishments in the U.S. from September 2021 to September 2022.

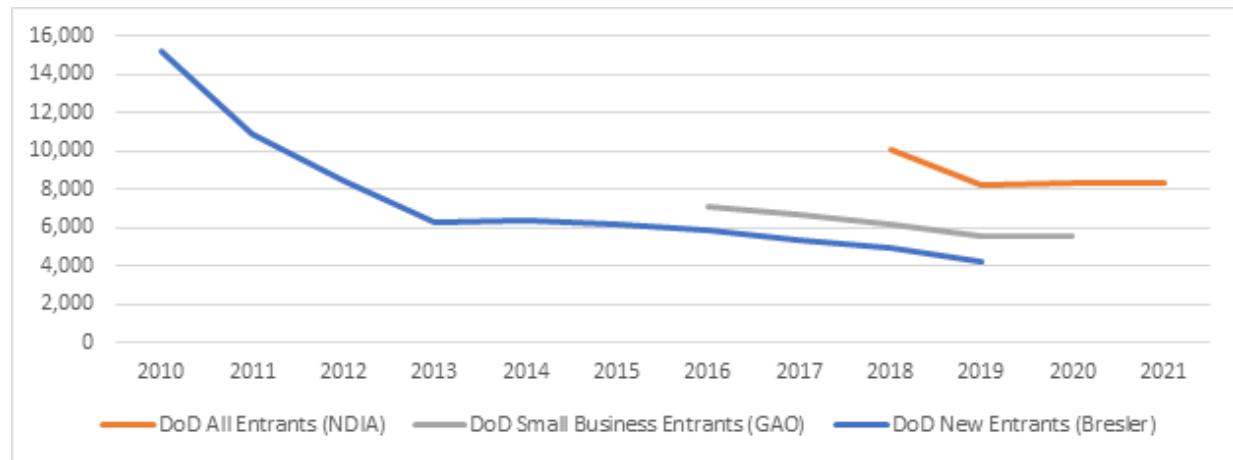
DoD's Outreach Efforts Are Not Changing the Underlying Trend

Over the past decade, DoD has made efforts to capture some of this growth

in the larger marketplace, with a specific focus on recruiting nontraditional defense contractors and start-up companies developing new technologies. In 2015, then Defense Secretary Ash Carter established the Defense Innovation Unit (then known as DIUx) “as part of the Defense Department’s outreach to America’s innovative technology companies.” (Department of Defense, 2016). DIU’s efforts are bearing some fruit. Between 2019 and 2022, DIU awarded 360 other transaction (OT) contracts to 321 unique vendors, many of which we believe are new to the NSIB. DIU, and its sister organization the National Security Innovation Network, are building a foundation for bringing in more companies in the future, generating proposals from companies that are not currently participating in the NSIB. (Defense Innovation Unit, 2022, pp. 8, 12).

What Is Driving Industry Away from the NSIB (and Hamstringing Those That Remain)?

Figure 5. Fewer Firms Are Entering the DIB



But these recruitment efforts are focused on a small subset of the NSIB and are not (yet) reversing the larger trend. As the latest Vital Signs report from NDIA highlights, the rate of new companies entering the defense marketplace is slowing. According to NDIA, from 2018 to 2021, the total number of companies entering the DoD marketplace decreased 17%, from 10,076, to 8,322 (NDIA, 2023, p. 13). Similarly, GAO (2021) found that from 2016 to 2020, the number of new small businesses contracting with DoD decreased 22%, from 7,083 to 5,526 (see figure 5).

WHAT IS DRIVING INDUSTRY AWAY FROM THE NSIB (AND HAMSTRINGING THOSE THAT REMAIN)?

At two recent events we asked attendees “Has your company considered pulling out of any government markets?” Twenty-five percent of respondents said *their companies have considered pulling out of at least some government markets*. What is striking about this response is that both events were geared toward companies in the federal government market.³ We then asked what factors most influence whether their companies participate in government contracts. Half of respondents cited “government-specific

3. The two events were the Practicing Law Institute’s Government Contracts 2022 (Oct. 26, 2022) and the NDIA Procurement Division Quarterly Meeting (Jan. 10, 2023).

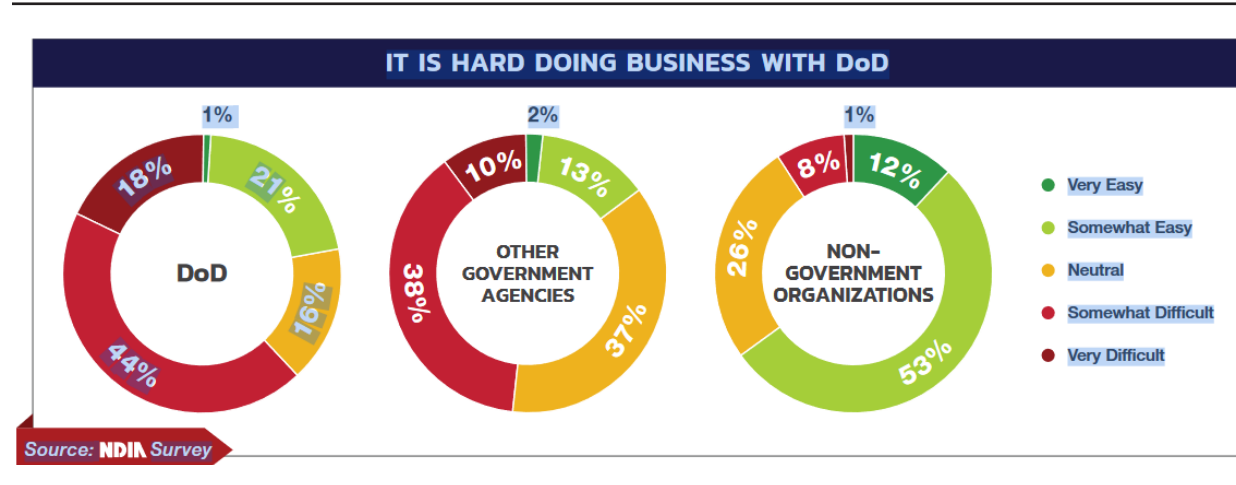
regulations that make it too hard or not worthwhile to work for government” as a strong or very strong consideration in deciding whether to contract with the government. Almost half of respondents cited “concerns over intellectual property integrity,” followed closely by “insufficient levels of cash-flow or profit margins.”

These polls were not scientific by any means.⁴ However, a larger poll conducted by NDIA reinforced our informal findings. When asked by NDIA “What is the most pressing issue facing the defense industrial base,” 30 % of those polled cited the burden of the acquisition process and paperwork, which ranked higher than concerns over budget stability, workforce, inflation, or any other issue (2023, p.

4. We did not control for any outside factors and our sample size was small, ranging from 121–152 respondents.

What Is Driving Industry Away from the NSIB (and Hamstringing Those That Remain)?

Figure 6. Views on Working with the Government



14). Respondents also indicated that it is much more difficult to do business with DoD than other agencies. Eighteen percent of respondents said it was “very difficult” to do business with DoD, compared to 10% for other government agencies, and 8% for non-government agencies (see figure 6).

Companies Want to Work with DoD—There Are Just Too Many Disincentives

There is another business model showing growth in the number of companies sell-

ing to DoD. Data on the use of consortia and other transaction authority convey a sense that when the traditional procurement rules are altered, more companies seek out opportunities to work with DoD. From FY10 to FY20, total membership in 12 consortia focusing on government contracting increased more than tenfold, from 365 to over 5,600. One consortium’s membership increased from 161 members in 2010 to 900 members in 2020. Another consortium attracted over 900 members in its inaugural year in 2019 (see

figure 7). (Schwartz and Halcrow, 2022)

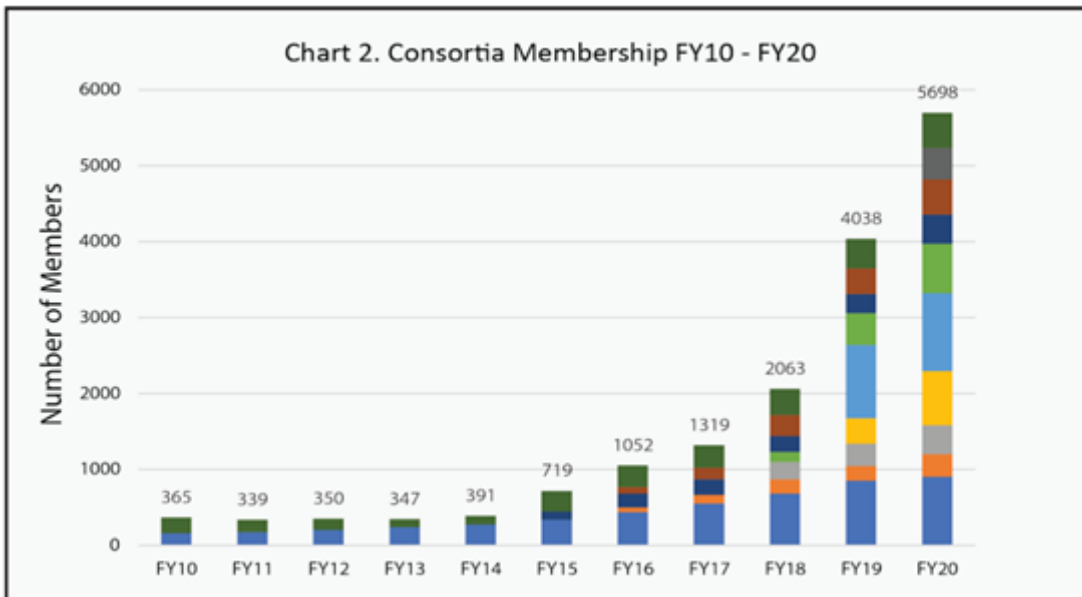
A large percentage of these businesses are nontraditional defense contractors, demonstrating the value of an arrangement that simplifies the process of working with DoD and enhances the benefits of collaborating with others in similar areas of expertise.

What attracts companies to consortia and other transaction agreements?

- An expedited and simplified method of contracting with the government—other transactions are not bound

What Is Driving Industry Away from the NSIB (and Hamstringing Those That Remain)?

Figure 7. Consortia Membership FY10–FY20 (Schwartz and Halcrow, 2022)



by most of the FAR or many other regulatory and legislative requirements.⁵

- Not having to deal with the government directly. According to the Executive Director of one company with 60 employees, “We would never have had this [contracting] opportunity without the consortia model” (Schwartz and Halcrow, 2022, p. 17).

- More communication and collaboration between government and industry,

and within industry.

The benefits of working within consortia are similar to the steps and recommendations being made by DoD’s outreach organization, DIU. DIU’s Director of Acquisitions Cherissa Tamayori (2023) attributes some of DIU’s success to their use of simplified acquisition processes, notably other transaction authority and commercial solutions openings. Tamayori also suggests that to continue this trajectory, “We must ensure that government needs align with best com-

mercial practices and do not require a company to create government-specific processes, develop costly proposals, or spend a year waiting to learn if it won a contract award.” If DoD and Congress simplified existing procurement rules and regulations and applied them more uniformly across the NSIB, an increase in the number of defense contractors would likely follow.

5. See 10 USC 4021 and 10 USC 4022.

The Budget Process as a Defense Industrial Base Challenge

DoD's budget process has a significant impact on the defense industrial base and procurement outcomes. The current budget process drives companies away from the defense market, hinders DoD's ability to attract private sector capital, and does not sufficiently signal to industry where to invest. In its recently released Interim Report, the Commission on Planning, Programming, Budgeting, and Execution Reform (2023) made the following observations:

- "Time-consuming DoD processes lead companies to walk away, depriving the Department of significant opportunities. The Commission also heard from small businesses that the technology they were developing did not exist when

the budget for that year was being built, and that waiting two or three years for funding is not a viable strategy for most small businesses." (pp. 26–27)

- "The difficulty of using innovative financial instruments and arrangements under the PPBE system also hinders the Department in its ability to attract private sector capital into the defense sector, especially in emerging technology areas where commercial RDT&E investment is much larger today than government investment." (p. 29)

- "The PPBE process is not well suited for signaling the credible possibility of a return on private investment in defense or in dual-use R&D through future DoD procurement of goods and services." (p. 30)

Are Defense Procurement Regulations Really Different Than Industry Practices?

Commercial companies seeking to enter the defense market must ensure that their supply chains, software and hardware content, sourcing, cybersecurity, accounting systems, and pay scale⁶ meet DoD and government-wide unique requirements. In combination, conforming to these requirements can be time-consuming and require significant upfront investment.

Some of these regulations, such as cost accounting system requirements, do not apply to small or non-traditional defense contractors, particularly those first starting to do work with DoD through other transaction authorities. However, understanding what requirements do and do not apply still requires some level of expertise. Instead of investing the effort necessary to get to this base understanding, some commercial companies default to the general conclusion that the burdens and challenges associated with government contracts are not worth it.

6. This requirement is primarily applicable to cost contracts.

A George Mason University study on government accounting system requirements noted that of the interviews they conducted, five out of twelve companies—or 41 percent—"reported not pursuing defense contracts due to the accounting requirements involved. In many cases, the decision to decline a contract was tangled with other compliance factors" such as fear of failing audits conducted by Defense Contract Audit Agency and unwillingness to invest resources to meet other FAR/DFARS requirements (Lofgren, 2022, pp. 2, 74).

Some non-traditional or small companies already working with the government have opted to remain non-traditional or small just to avoid those regulations that apply to larger or traditional defense contractors. Lofgren (2022) notes two examples. In one case, a small services company "has strategically chosen to not become FAR/DFARS compliant. '[It's] too difficult to get involved with the federal government. We've made decisions not to proceed on certain programs, too high on the regulatory side, didn't make sense to us.'" Another company, a small manufacturing supplier, shared that "we won't comply with cer-

tain standards. . . . Until we get to a point where the government accounting is not onerous, we're not going to consider it." (p. 74) The government-specific accounting requirement, especially as part of the aggregate compliance burden, disincentivizes companies from expanding their work with DoD.

Some of these government-unique regulations (such as domestic content requirements) drive up the cost of goods and services provided by companies. Given that most companies in the defense industrial base sell into both government and commercial markets, government-unique regulations that drive up the cost of products sold into commercial markets can threaten a company's ability to compete and survive outside of government contracts.

A few case studies illustrate this burden and increased cost. At the April 2023 Sea Air Space expo, a representative from a midsize technology company that sells commercial goods to the U.S. Coast Guard stood up during Q&A to ask DIU's Cherissa Tamayori how industry can help DoD better use its rapid acquisition authorities. Despite this company providing commercial goods, he claimed

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that none of his contracts had ever used FAR Part 12 (“Acquisition of Commercial Products and Services”). By his telling, accounting for the extra and unnecessary burden of complying with the full FAR requirements drove up the costs for these supplies by 20–30%.

Another example comes from a foreign supplier of an underwater camera to a defense prime. To account for the potential risk of accepting FAR clauses, conditions, and requirements they didn’t understand, the sub doubled the cost of the camera from approximately \$200,000 (commercial price) to \$400,000.⁷

To stay in the defense market, companies must absorb the cost of tracking constantly changing restrictions, prohibitions, and requirements of the procurement system, a task that is difficult for even the most sophisticated defense contractors—and an insurmountable challenge for many medium-sized commercial companies. Appendix B is a list of prohibitions or restrictions that were working their way through the rule-making stage or recently implemented as of March 1, 2023, including the following:

Restrictions on contractors using certain goods or services even if the goods and services are not used on a DoD contract:

- Prohibitions on the use of Chinese telecommunications equipment
- Prohibitions on the use of Unmanned Aircraft Systems from certain foreign countries
- Prohibitions on the use of certain semiconductor products or services

Other restrictions or requirements:

- Disclosing to DoD the source for certain permanent magnets in products or services

⁷. Conversation with author, April 5, 2023.

Some see private enterprise as a predatory target to be shot, Others as a cow to be milked, but few are those who see it as a sturdy horse pulling the wagon

Sir Winston Churchill

- Expanding the prohibition on procuring certain rare earths, strategic and critical minerals, or energetic materials from certain Chinese entities
- Prohibitions on certain items mined, produced, or manufactured in the Chinese Xinjiang Uyghur Autonomous Region
- Prohibitions on certain printed circuit boards from China
- Requirements to disclose employees working in China on DoD contracts
- Expanding the prohibition on certain metals, to include materials mined, refined, or separated in China
- Cybersecurity requirements to contract with DoD (CMMC)
- Gradually increasing domestic content requirements for the Buy American Act, increasing to 75% in 2029.

Most of these restrictions stem from legislation that can only be undone by Congress. Some of these regulations date back to legislation passed in 2018. In other cases, Congress passed laws to amend previous legislation whose regulations have still not been promulgated and issued.

The still-to-be-implemented rules are on top of current requirements, including

- The Berry amendment
- Specialty metal requirements
- Truthful Cost or Pricing requirements (formerly known as the Truth in Negotiations Act)
- Cost Accounting System requirements

- Wage caps for certain cost contracts

While most of these rules and regulations are not applicable to commercial firms seeking to do business with DoD, they add to the complexity of the overall marketplace. Since March 1, new Executive Orders and proposed regulations have been issued, and more are on the way. The House and Senate versions of the Fiscal Year 2024 National Defense Authorization Act contain more than a dozen sections that would likely lead to new or amended regulations.

Incumbent defense contractors often support the larger goals of many individual requirements and have resources dedicated to complying with government-unique terms, conditions, and business processes. But even these long-term partners have grown weary of the ever-increasing complexity of doing business with DoD.

In 2021, for example, three industry groups representing technology companies selling to DoD wrote a letter to Deputy Secretary of Defense Hicks about the uncertainty surrounding CMMC—a requirement that was announced in 2019, evolved into version 2.0 in 2021, and has yet to be implemented. That letter expressed support for improved cybersecurity practices but noted that the uncertainty of how CMMC will be executed is compounded by “the continued proliferation of federal cybersecurity requirements at the agency level ... [and] causes operational impacts that result in procurement inefficiencies and contractual modifications that are passed on to the Government.” This complexity also slows or stops efforts to modernize and comply: “[C]ontractors, subcontractors, and suppliers may defer substantial investments pending communication and greater certainty about the program’s requirements.” (Information Technology Indus-

try Council, National Defense Industrial Association, and Professional Services Council, 2021).

One of the simple suggestions these groups make is better communication: “We believe DoD and industry will achieve the best risk management outcomes when they engage in bi-directional information sharing and act transparently in their decision-making” (Information Technology Industry Council, National Defense Industrial Association, and Professional Services Council, 2021). Intentional and frequent communication between DoD and industry has long been recognized as a best practice—yet efforts to embed more transparency in the acquisition process have been inconsistent and not widespread enough.

Other regulations are driven by fear of contractor fraud, waste, and abuse. Having the right oversight mechanisms are important to safeguard the interests of government and the taxpayer. But there is a tipping point where the cost of excessive oversight and compliance exceeds the benefit. In some instances, cost and pricing requirements designed to protect the government actually increase costs, delay time to contract, and cause companies to forgo competing for contracts.

Recognize the Root of the Problem

There is much blame to go around as to the current state. Congress, DoD, industry, and the oversight organizations share responsibility. But the most important step to expand, strengthen, and revitalize the NSIB is for DoD and Congress to understand that they have the largest impact on the NSIB and marketplace behavior. DoD has not truly embraced that its own policies, regulations, and culture are the primary source of the problem. In its February 2022 report, *State of Competition within the Defense Industrial*

“for far too long, it’s been far too hard for innovators and entrepreneurs to work with the department.”

Secretary of Defense Lloyd Austin

Base, the Office of the Under Secretary of Defense (A&S) stated:

To counteract the trend of overall shrinking of the DIB, DoD should endeavor to attract new entrants to the defense marketplace by reducing barriers to entry. This will be accomplished through small business outreach, support, and use of acquisition authorities like other transaction (OT) authority and commercial solutions opening (CSO) that provides DoD the flexibility to adopt and incorporate commercial best practices to reduce barriers and attract new vendors. (OSD A&S, 2022, p. 2).

Unfortunately, “outreach” is not the problem, and other proposed DoD solutions do not address the root causes of what is happening. DoD is the largest buyer in the United States, and companies of all stripes are well aware of its buying power. But they are also aware of the challenges of working with the department. Increasing the use of different contracting vehicles like other transactions, while a positive step, is not a solution. And as DoD slowly puts more regulation and bureaucracy on OTs, Middle Tier Authorities, and other flexibilities, the value proposition of these contracting vehicles decreases.

DOD NEEDS A STRATEGY FOR RETAINING—NOT JUST RECRUITING—BUSINESS PARTNERS

The steps DoD has taken to attract new

companies are insufficient to reverse the trend of a shrinking NSIB, in part because the department—and the federal government as a whole—does not have an effective strategy for retaining companies once they join the national defense innovation and industrial base. The challenges they face are either unknown or deemed acceptable friction inherent to how DoD conducts business. Before they can reverse the current industrial base trends, Congress and DoD would benefit from a foundational change in how they think about the industrial base throughout the full lifecycle of the acquisition relationship.

But at its heart, acquisition is a human endeavor of building and sustaining relationships.

Defense acquisition is too often executed as a mechanistic process focused on checklists, regulations, and processes rather than a relational process focused on shared priorities, better outcomes, and mutual respect. Attempts to ensure consistent oversight and accountability across an enormous bureaucracy have produced a mechanistic approach that discourages individualized solutions, creative thinking, teamwork, and trust. But at its heart, acquisition is a human endeavor of building and sustaining relationships. More regulation does not produce greater outcomes. Rather, fewer regulations, more consistently enforced, coupled with empowering acquisition professionals to think, will reap greater acquisition rewards.

DoD Should Get a Relationship Therapist

The relationship between DoD and

Intellectual Property and Data Rights

Nothing will drive a company away from DoD faster than fear of losing control over its IP. Chapter 275 of Title 10, *Proprietary Contractor Data and Rights in Technical Data* opens with this principle, written as a requirement for the Secretary of Defense

The Secretary of Defense shall prescribe regulations to define the legitimate interest of the United States and of a contractor or subcontractor in technical data pertaining to an item or process.

The interests of the United State in proprietary and technical data are straightforward—the more DoD owns and has access to such data, the easier it is for DoD to ensure technology can be sustained over its lifecycle, either in-house or by a contractor who competes for and gains access to these rights from DoD. What is less recognized is that it is in the long-term interest of DoD to protect industry’s rights in proprietary and technical data. The most recent NDIA report on the health of the industrial base stated:

Intellectual Property rights are essential to the health of the DIB. The perception of risks to IP rights shapes investor’s willingness to invest in research and development and commercialization activities. (NDIA, 2022, p. 36).

IP rights represent the crown jewels of industry, and the lifeblood of company competitive advantages. Too often,

DoD seeks broader IP and technical data rights without wanting to pay for such rights. Sometimes, the effort to mandate delivery of data rights has an unanticipated effect on DoD. As one company told us, when DoD seeks to mandate delivery of data rights without providing compensation, it is easier to sell the IP rights to another company even when we know that company will jack up the price and charge DoD more.

Efforts are underway both in DoD and industry to find a balance between government and industry perspectives. The IP Cadre established in the FY 2020 National Defense Authorization Act is working to establish processes and policies for evaluating IP rights. Discussions with industry began in earnest in 2022, and a handful of case studies are underway to identify best practices (Department of Defense, 2023). In August 2023, Assistant Secretary of Defense for logistics, Chris Lowman, suggested a model he called “IP as a service,” where DOD negotiates a royalty and pays the contractor when it prints a part (Nieberg, 2023b).

These and other efforts are moving in the right direction but they are still very much nascent. Notably, the key step to success will be training the acquisition workforce to understand these best practices and to apply core principles to sophisticated situations. Effectively and consistently negotiating IP rights throughout the acquisition lifecycle is still a future goal, not yet a reality.

industry is dysfunctional (partly due to the third wheel of Congress—but that’s another paper). While we are not relationship experts, our research and experiences have indicated that the keys to a strong relationship include

- Understanding the needs of the other party,
- Having open and honest communication, and
- Seeking a win-win common ground that accepts compromise.

Understand Industry

DoD generally does not have a solid

understanding of how industry operates and what motivates companies, drives business decisions, and, most importantly, prompts companies to leave (or not enter) the NSIB. The first step in developing a more beneficial relationship with industry is for DoD to better understand their needs and priorities. DIU’s Cherissa Tamayori (2023) makes one of her three suggested strategies for improved acquisition to “understand industry partners and align to common business practices.” One of the differences the DIU team has found is that “many companies, especially those supplying software-based technol-

ogies, have pivoted to a service-based model.” Tamayori admits that acquiring technology this way “requires a mindset shift” in defense acquisition.

Research on the differences between business-to-business (B2B) and business-to-government (B2G) processes provides some additional insight:

“The inflated cost of B2G exchanges outweigh the scale and efficiency benefits until the firm reaches a critical threshold. Firms with a stronger government customer emphasis also experience more performance volatility (as

Contracting at the Speed of Relevance

According to a Bloomberg government-wide analysis, “[T]he time it takes between the release of a final solicitation to the award of a contract—procurement acquisition lead time, or PALT—rose 72% in five years” (Murphy, 2021). While DoD performed better than most agencies, with an average PALT of 63 days, prime contracts with estimated values of more than \$100 million—including weapon and IT systems—averaged 308 days (Murphy, 2021). Particularly delayed programs included the Air Force’s Enterprise Cyber Capabilities at over 790 days, the Army Common Hardware Systems-6th Generation (640+ days), the Air Force’s Mission Partner Cmd/Ctrl/Intel Infor Sharing (630+ days) and the

Army’s TADSS Maintenance Program 2 (280+ days).

According to a recent report conducted by NDIA, when industry members were asked, “What is the most important thing the federal government can do to help the Defense Industrial Base?,” their top answer was “streamline the acquisition process.” (NDIA, 2022, p. 54). In business, time is money, and the delays in awarding contracts and executing agreements is a strong disincentive to work for DoD. Such delays also increase costs to contractors (which are ultimately passed on to DoD) and delay capabilities from getting to warfighters.

revealed in idiosyncratic and systematic risk) due to the difficulties of redeploying and safeguarding [transaction-specific investments] from unanticipated changes in government procurement activities. That is, firms face significant asset specificity in B2G exchanges because of the federal government’s idiosyncratic nature, so the projected cash flows from B2G exchanges are more volatile.” (Josephson, Lee, Mariadoss, and Johnson, 2019).

Other common industry values are an unwillingness to relinquish IP rights, the ability to operate with unlimited profit margins, and the potential for cashflow that evolves at pace with changing costs or other growth opportunities.

The risks of selling to DoD are increasing, while profits are decreasing:

The traditional Wall Street view of the defense industry is that it should demand lower multiples than the technology industry as it possesses less revenue risk having the Depart-

ment of Defense as its primary customer. However, with year-over-year variations in the defense budget and high-value transaction fluctuations in the Foreign Military Sales program, revenue volatility can actually be much higher than expected. Given that contract revenue volatility can result in lower margins, the major defense contractors seek alternative methods of revenue stability. . . . *Stabilized revenue generation and high margins are limited by fluctuating policies and budgets* while competitive advantages are disrupted by innovative new companies, so the primes utilize their balance sheets and respond with acquisitions and consolidation, *further reducing production capacity to save costs.* (Van der Colff, 2023, emphasis added)

Businesses don’t thrive when the primary metric of success is low price. Nor do customers. The current challenge of replenishing supplies sent to Ukraine illustrates that an effective defense indus-

trial base operates with redundancy, flexibility, and surge capacity. Leaders in DoD and Congress are now admitting the weaknesses of just-in-time inventory strategies and are employing rapid acquisition strategies, especially for supplies considered necessary for national security. The establishment of the Joint Production Accelerator Cell in March 2023 begins a larger outreach to existing defense contractors to build “enduring industrial production capacity, resiliency, and surge capability.” (LaPlante, 2023). As this and other efforts pick up speed, we are starting to see the potential of what it could look like when this relationship is nurtured around a shared commitment to mission. Such enhanced communication should be institutionalized as the rule, not the exception.

Better Communication

The key to any successful relationship is communication, listening, understanding the other’s needs and perspectives, and working to find the middle ground

The Times They Are a-Changin’

that meets the needs of all parties concerned. This is not DoD’s strong suit. Many contracting officers opt not to have robust communication with industry, often out of fear of protest or violating a regulation. More robust communication has many advantages. Some analysts believe that increased communication has helped reduce the number of bid protests (Konkel, 2022). One senior industry official told us that they prefer other transaction authority contracts because DoD contracting officials tend to be more communicative in negotiations.

The benefit of enhanced communication between industry and government/DoD is no secret. OMB’s Myth-Busting memo #4 reminds acquisition professionals of all the channels of communication available to them and asks each agency to appoint an industry liaison (Field, 2019). In an effort to spur more communication, on December 1, 2022, a new Federal Acquisition Regulation final rule was published, *Effective Communication between Government and Industry*, to make clear “that agency acquisition personnel are permitted and encouraged to engage in responsible and constructive exchanges with industry, so long as those exchanges are consistent with existing law and regulation and do not promote an unfair competitive advantage to particular firms.” More frequent and ongoing communication between industry and DoD will help DoD better understand industry and help create compromise that can most effectively achieve the shared mission of ensuring national security priorities.

Build a Win-Win Relationship

Too often, in an overzealous effort to drive down cost, conduct oversight, protect DoD interests, or improve performance, DoD takes a win-at-all-cost-on-every-issue approach. Such an

approach may save some money, garner more IP rights, or facilitate a far-reaching oversight regime in the short-term, but the long-term consequences have contributed to a less robust, less resilient, and less dynamic NSIB. DoD should embark on a win-win approach that focuses on nurturing its relationship with industry, recognizing industry needs, and being a more supportive partner with industry.

Streamline the Relationship to Be Less Beholden to Regulations and Easier to Navigate

DoD should undertake a comprehensive analysis of what statutes, regulations, and policies are driving industry to leave the NSIB. Armed with such information, DoD could then submit legislative proposals to Congress and initiate regulatory changes to the Federal Acquisition Regulation and the Defense Federal Acquisition Regulation Supplement that are aimed at rebuilding industry participation in the government marketplace while still maintaining the necessary oversight.

As Pete Modigliani (2023) suggested, DoD should survey the approximately 60 Program Executive Officers on the most significant bureaucratic barriers and regulatory impediments to operating with greater speed and agility and figure out how to remove these barriers (while maintaining necessary oversight). Such an effort could focus on repealing or eliminating those statutes and regulations whose value does not significantly outweigh the cost of an overly complex acquisition system, conducting a cost/benefit analysis to determine if certain thresholds should be raised.

Finally, DoD should continue the progress made in reorganizing Title 10 and take the next step: harmonizing the cluttered notes that make a holistic

understanding of the codified defense acquisition regulations nearly impossible.

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Congress has provided DoD with acquisition authorities such as other transaction authorities, commercial buying procedures, and expanded use of multi-year procurements. For its part, the Department is starting to change, driven in large part by the experience of Ukraine and by the commitment of current leadership. As Under Secretary of Defense (Acquisition & Sustainment) Bill LaPlante recently testified, “the Department continues to evolve our policies, processes—and most importantly—our culture” (LaPlante, 2023b). DoD is also dedicating funding to address the industrial base challenge, including its use of Defense Production Act authorities and funds, and in the FY2024 budget request, “continuing widespread investment to strengthen the industrial base” to include roughly \$6 billion into “foundational sectors such as microelectronics and castings and forgings to facilitate overall industrial base resilience.”

These moves are setting the stage to reverse the trends in the industrial base outlined above. Significant change must continue and expand to create a fundamentally new way of doing business.

CONCLUSION

Current government acquisition rules are depriving DoD from consistently getting the benefits of the best industry talent, the best commercial capabilities, and quicker transition and deployment of needed capabilities. If the regulatory

burden and negative incentives are not addressed head on, no amount of outreach or training will bring businesses back into the defense marketplace—or keep them from leaving.

In 2022, DoD issued the report *State of Competition within the Defense Industrial Base*. We believe DoD got it backwards in that report. The question is not, what is the state of competition within the defense industrial base to win DoD's business? It is, what is DoD (and Congress) doing to compete with commercial market buyers to induce industry to work with DoD?

Until the federal government looks inward and matches policies to the realization that it cannot dictate to industry the terms of contracts, DoD will often get what it pays for: goods and services that are more focused on meeting compliance requirements and driving to lowest cost than they are on innovation, capability, and speed. Those results will not position the United States military to deter, defend against, or dominate adversaries.

In this decisive decade, acquisition regulations and policy must be streamlined to deliver outcomes and informed by data gathered through continued analysis of the shrinking defense industrial base from multiple perspectives—and most importantly, through difficult conversations with industry partners.

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