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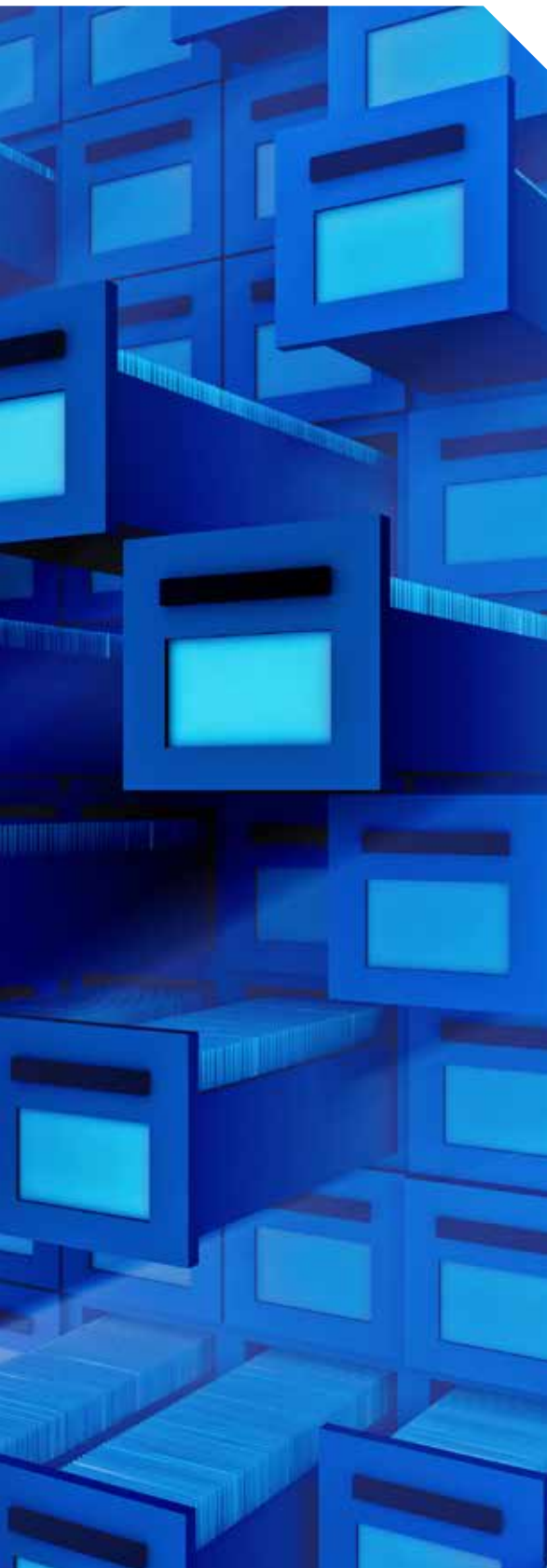
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How Not to Alienate Business Partners

In Part One of this two-part series, we explore what contracting professionals should know about recent changes in the defense industrial base.

By Moshe Schwartz and Michelle V.J. Johnson



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 United States economy.

In recent years, however, the NSIB has started to detach from the overall 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.

This article examines the reasons companies may choose to leave the NSIB (or not enter it in the first place), noting that defense acquisition, budget, and business processes are continuing to grow more complex, more heavily regulated, and more out of sync with the private sector. In a second article to be published next month, we continue the conversation by suggesting steps contracting professionals and DoD leadership can take to build stronger relationships with current and potential industry partners.

Implications of a Shrinking NSIB

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%.² But this is not a small business story – it’s 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.³

The NSIB continued to shrink in 2022 across both small and larger businesses and across both DoD and government-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.⁴

A separate Bloomberg analysis reveals a drop in defense contractors of 2,854 vendors from FY2021 to FY2022,⁵ 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 Bresler) is different, they all show a clear downward trend in contractor participation in the

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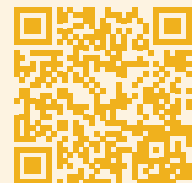
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government marketplace.⁷

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 ringing.

Some analysts, including even DoD's assessment of the defense industrial base, have attributed the decline primarily to mergers and acquisitions.⁸ While mergers and acquisitions continue to occur in the defense marketplace, those

numbers pale in comparison to the larger trends. A study conducted by HigherGov identified 433 mergers and acquisitions in the aerospace, defense, and government sector in 2022.⁹ Comparing this data to the Bloomberg numbers, this consolidation accounts for approximately 15% of the drop in defense contractors.

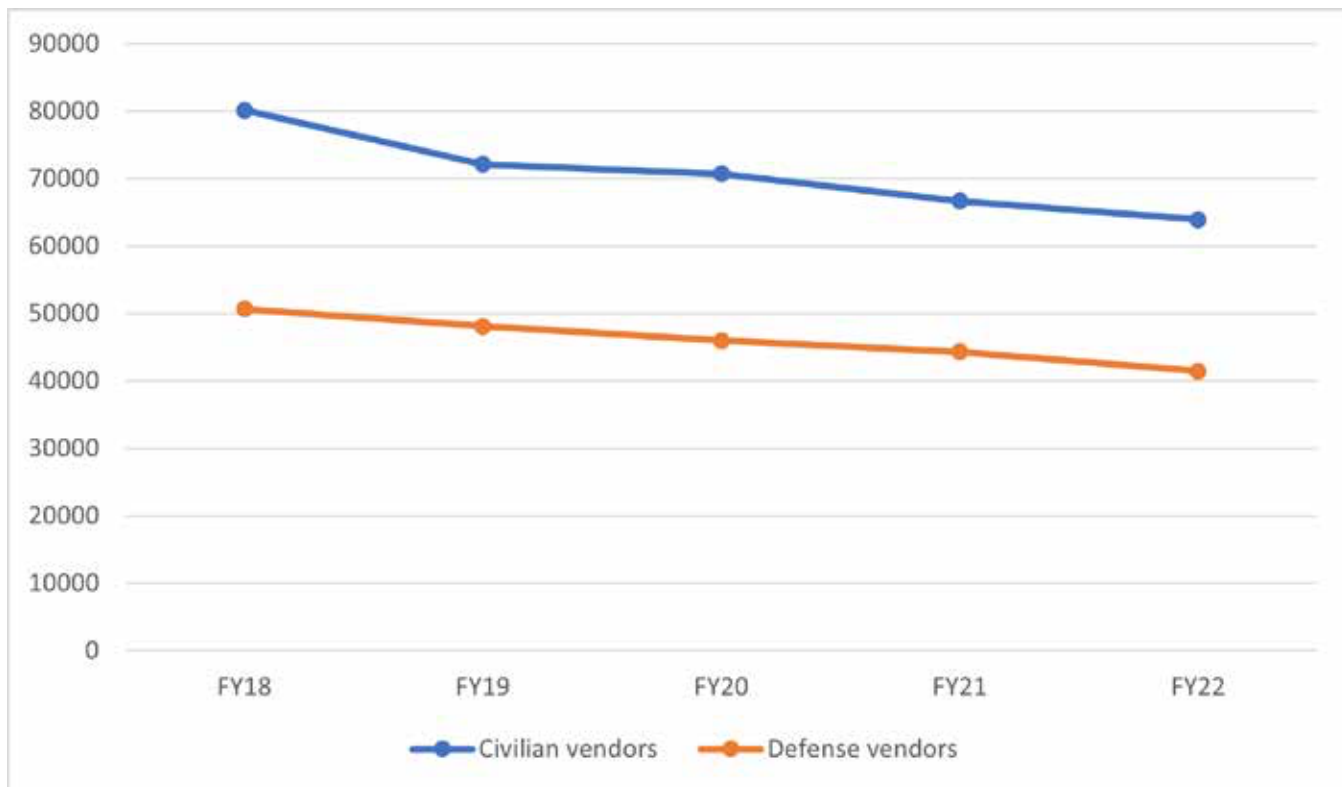
Furthermore, mergers, acquisitions, and takeovers are not unique to the defense sector. They occur in the larger U.S. economy, which nonetheless continues to grow, both in dollars and the number of businesses. The number of businesses

in the U.S. economy increased by 7% from 2010 to 2019 and the number of applications for new businesses almost doubled from 2011 to 2022, from 2.58 million to 5.1 million filings.¹⁰

DoD's Outreach Not Reversing the Trend

Over the past decade, DoD has made efforts to capture some of this growth of new applicants in the larger marketplace, with a specific focus on recruiting nontraditional defense contractors and start-up companies developing new technologies. In 2015,

FIGURE 1. Defense Supplier Base Down as Overall Federal Contractor Count Falls



Source: Bloomberg Government.⁶

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.

FIGURE 2. Trends in Contractor Participation in the Government Marketplace

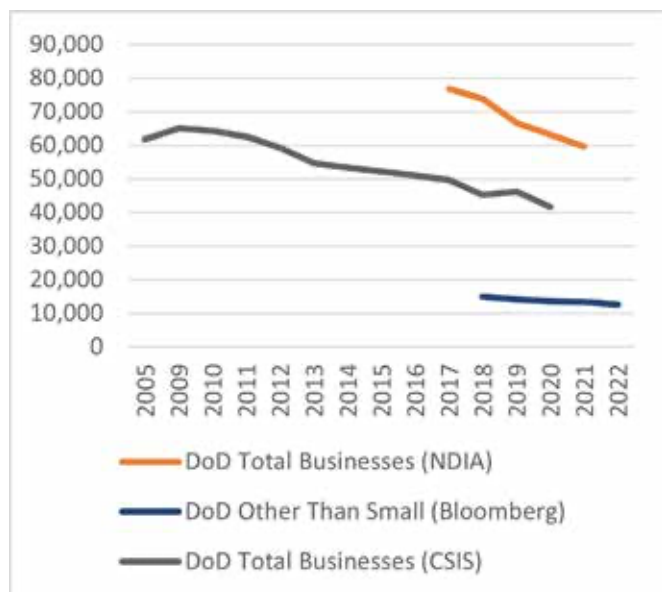
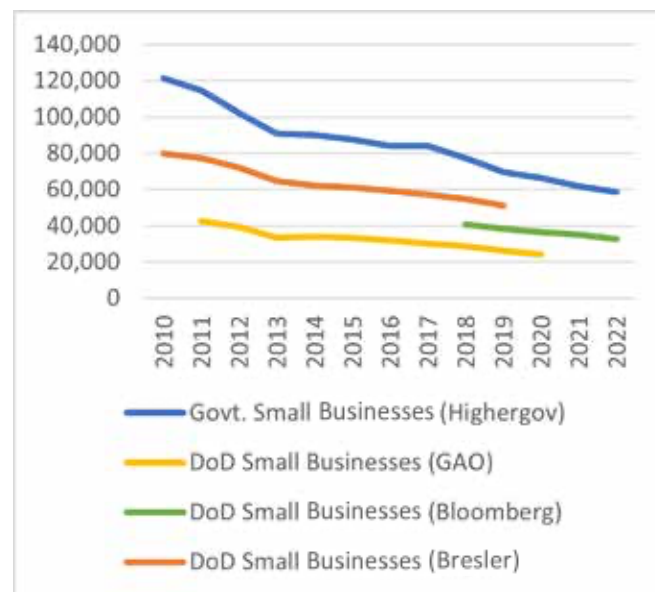


FIGURE 3. Trends in Small Business Participation in the Government Marketplace



then Defense Secretary Ash Carter established the Defense Innovation Unit (DIU, then known as DIUx) “as part of the Defense Department’s outreach to America’s innovative technology companies.”¹¹

While DIU’s efforts are bearing some fruit, 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 8,322.¹² Similarly, GAO (2021) found that from 2016 to 2020, the number of small businesses contracting with DoD decreased 22%, from 7,083 to 5,526 (see Figure 4).

What Is Driving Industry Away From the NSIB

To understand this phenomenon, we conducted an informal survey of current defense contractors and identified three areas of concern. When asked, “Has your company considered pulling out of any government markets?,” 25% of respondents answered “Yes.” When asked what factors most influence whether their companies participate in government contracts, half of respondents indicated “government-specific regulations that make it too hard or not worthwhile to work for government” as a strong or very strong factor. This top concern was closely followed by “concerns over intellectual property integrity” and “insufficient levels of cash flow or profit margins.”

These polls were not scientific by any means.¹³ 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.

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 5).¹⁴

Are Defense Procurement Regulations Really Different Than Industry Practices?

Companies doing business in the defense marketplace are subject to

many requirements not found in the commercial sector. These could pertain to supply chains, software and hardware content, sourcing, cybersecurity, accounting systems, and pay scale.¹⁵

While many small and nontraditional companies are not bound by all these requirements, any defense contractor must nonetheless invest

time and expertise to understand which restrictions apply and which do not. Adding to the complexity, every year brings changes to the list of government-unique restrictions, prohibitions, and requirements.

This compliance burden is well known to those in defense contracting, including DoD leadership. In a recent interview, John

Tenaglia, Principal Director, Defense Pricing and Contracting, Office of the Under Secretary of Defense for Acquisition and Sustainment, admitted that new requirements are being issued faster than the rule-making system can keep up with.¹⁶ Some recent additions to this backlog are coming from new presidential agendas for equity,

FIGURE 4. Fewer Firms Are Entering the Defense Industrial Base

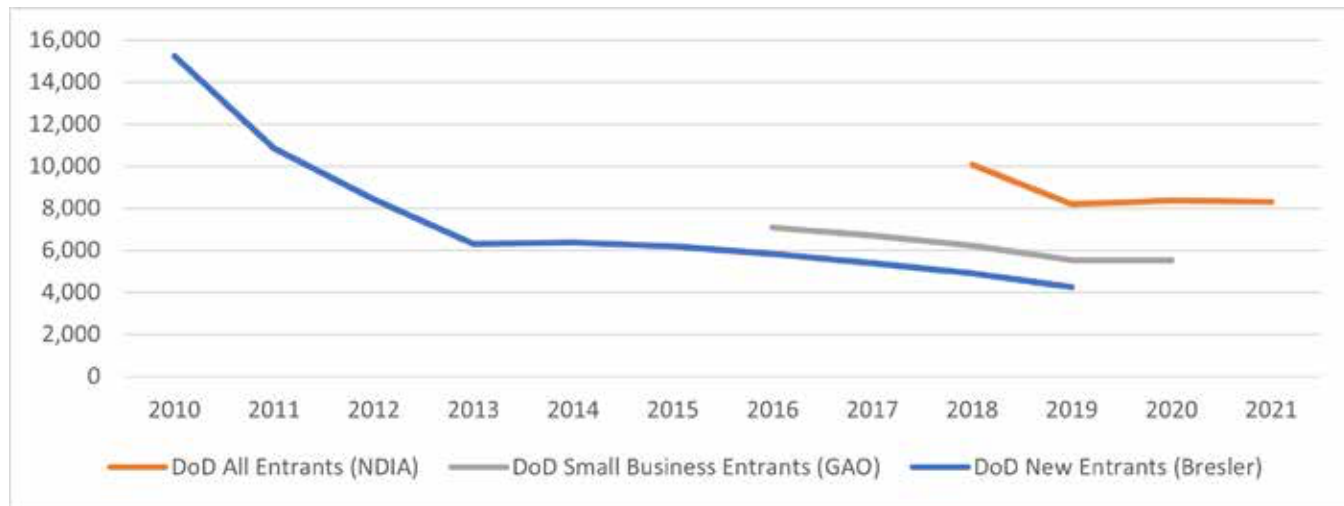
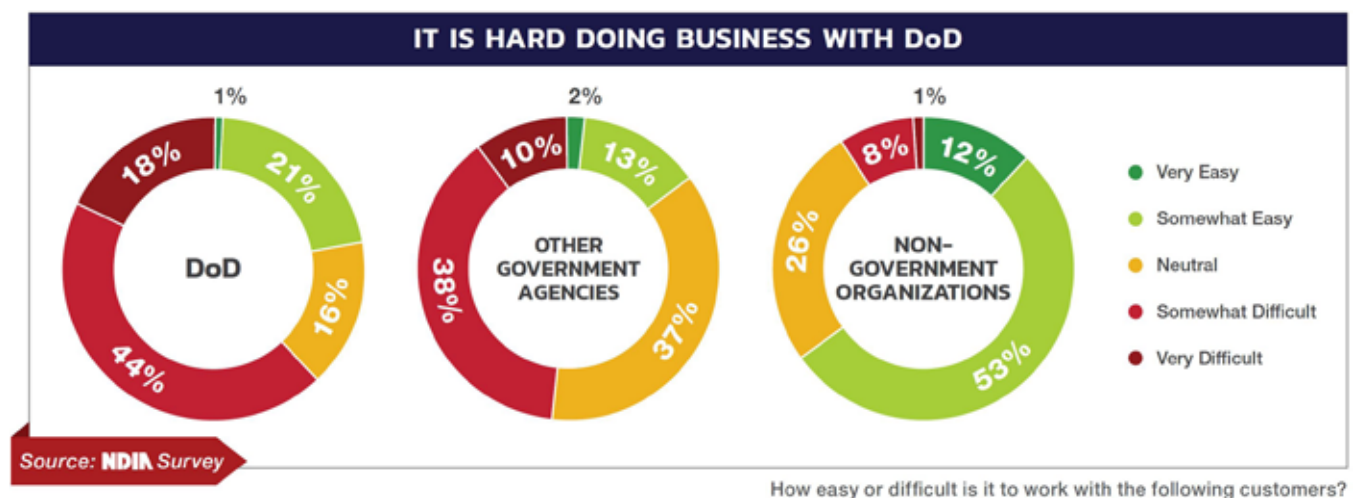


FIGURE 5. Views on Working With the Government (Source: NDIA)



climate, and domestic sourcing, each of which will create new rules and contract clauses.

As of September 29, 2023, DoD listed more than 60 open FAR cases¹⁷ ranging from a 2015 prohibition on providing funds to the enemy to the 2023 prohibition of TikTok on government devices. And this list is constantly changing. The conference version of the Fiscal Year 2024 National Defense Authorization Act contains more than a dozen sections that would likely lead to new or amended regulations.

In Part Two: Proven Solutions

While the challenges identified in this article are serious and complex, the good news is that these problems are well-known, and potential solutions have already been identified. Even better, some of these solutions are being implemented. In the second part of this article, to be published in the March 2024 issue of *Contract Management* magazine, we will explain what streamlined relationships between industry partners and the DoD look like and what contracting professionals can do to continue building these relationships. **CM**

Moshe Schwartz is President of Etherton and Associates, a consulting and lobbying firm specializing in defense acquisition, industrial base, and cybersecurity policy. Previously, Moshe served as Executive Director of the congressionally mandated Advisory Panel on Streamlining and Codifying Acquisition Regulations (the Section 809 Panel) and authored numerous reports at the Congressional Research Service and GAO.

Michelle Johnson is Communications Manager at the Acquisition Research Program at Naval Postgraduate School. Prior to joining NPS, she was a research associate and communications manager for the Section 809 Panel.



ENDNOTES

- 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.
- 2 U.S. Government Accountability Office. (2021, October 14). Small business contracting: Actions needed to implement and monitor DoD's small business strategy. <https://www.gao.gov/products/gao-22-104621>
- 3 U.S. Government Accountability Office. (2021, October 14). Small business contracting: Actions needed to implement and monitor DoD's small business strategy. p. 9. <https://www.gao.gov/products/gao-22-104621>
- 4 Nieberg, P. and Murphy, P. (2023, February 8). Labor shortages in US hamper defense manufacturing efforts. Bloomberg Law. <https://news.bloomberglaw.com/immigration/labor-shortages-in-us-hamper-defense-manufacturing-efforts>
- 5 Murphy, P. 2023. House panel to ask industry about declining pentagon vendor base. Bloomberg Government. <https://about.bgov.com/news/house-panel-to-ask-industry-about-declining-pentagon-vendor-base/>
- 6 Murphy, P. 2023. House panel to ask industry about declining pentagon vendor base. Bloomberg Government. <https://about.bgov.com/news/house-panel-to-ask-industry-about-declining-pentagon-vendor-base/>
- 7 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 others are consistent.
- 8 See, for example, the 2022 DoD report State of Competition in the Defense Industrial Base.
- 9 Siken, J. (2023, January 11). Aerospace, defense, and government M&A review. HigherGov. <https://www.highergov.com/reports/year-end-ma-review-2022/>
- 10 U.S. Census Bureau. (2023, March 29). Business Formation Statistics. [https://www.census.gov/econ/currentdata/dbsearch?programCode=BFS&startYear=2011&endYear=2023&categories\[\]=TOTAL&dataType=BA_BA&geoLevel=US&adjusted=1¬Adjusted=1&errorData=0#table-results](https://www.census.gov/econ/currentdata/dbsearch?programCode=BFS&startYear=2011&endYear=2023&categories[]=TOTAL&dataType=BA_BA&geoLevel=US&adjusted=1¬Adjusted=1&errorData=0#table-results)
- 11 Department of Defense. (2016, October 13). DIUx official: Working at 'speed of business' to bring tech to warfighters. <https://www.defense.gov/News/News-Stories/Article/Article/973315/diux-official-working-at-speed-of-business-to-bring-tech-to-warfighters/>
- 12 National Defense Industry Association. (2023, February). Vital signs 2023: Posturing the U.S. defense industrial base for great power competition, p. 13.
- 13 We did not control for any outside factors and our sample size was small, ranging from 121-152 respondents.
- 14 National Defense Industry Association. (2023, February). Vital signs 2023: Posturing the U.S. defense industrial base for great power competition, p. 14.
- 15 This requirement is primarily applicable to cost contracts.
- 16 Miller, J. (2023, September 28). Pentagon works with Congress to limit new acquisition compliance burdens. Federal News Network. <https://federalnewsnetwork.com/ask-the-cio/2023/09/pentagon-works-with-congress-to-limit-new-acquisition-compliance-burdens/>
- 17 "Open FAR Cases." Defense Pricing and Contracting. <https://www.acq.osd.mil/dpapr/dars/opencases/farcasenum/far.pdf>



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