

## STATEMENT by PHILIP ODEEN

Senate Armed Services Committee  
Subcommittee on Emerging Threats and Capabilities

Good Afternoon,

I appreciate the opportunity to appear before you today. The Defense Industrial Base is a vitally important issue, but one that seldom gets attention from the Congress. It is a perfect example of issues that President Eisenhower described as ‘critical but not urgent.’

### **The Industrial Base Today**

The large Defense industrial companies are in sound condition today; strong revenue and cash flow, growing profits, and impressive balance sheets with limited debt and investment grade credit ratings. This is in stark contrast to the Industrial Base a dozen years ago, following a decade of sharp reductions in Defense spending and the massive consolidation of the traditional industry players following the so-called “last supper,” hosted by Secretary Perry. Revenues had declined along with profits, cash flow was weak (in part due to DoD policies), and the surviving companies had heavy debt loads and non-investment grade credit ratings. They also had an aging workforce and found it difficult to attract well-qualified technical and engineering talent.

Today’s Defense Industrial Base is healthy in areas beyond its financial condition. Human capital has been rebuilt after a decade of attracting quality college graduates and experienced technical and engineering talent. This is due largely to the weak industrial economy and the good wages and benefits Defense industry offers. But I believe the attitude of our people post 9-11 contributes as well.

While the large primes and most major subcontractors are in good condition, the lower tier suppliers are a different story. The recent recession impacted many of them severely. Most of these firms primarily sell to larger commercial manufacturers, and commercial demand dropped sharply in 2008. A number of small companies providing items such as forgings and specialized components went bankrupt or had to close selected operations. Defense industry was able to work through these issues, but problems still remain. In many ways, these 3<sup>rd</sup> and 4<sup>th</sup> tier suppliers are the weakest link in the Defense industry supply chain. Hopefully the current recovery of the broader manufacturing sector will reduce the risks going forward.

DoD, however, relies on a much larger web of suppliers beyond the well-known aerospace and defense primes. In many areas such as electronics, information technology, and communications, most of the new technologies reside in the commercial world – frequently in firms based outside our borders. Here DoD’s outlook is far less positive. The policy changes made in the 1990s to facilitate DoD’s access to the commercial world have largely been eroded. As a result, DoD is again forced to rely heavily on its traditional suppliers and sources of technology.

### **Access to Technology**

Looking beyond DoD’s limited access to commercial technology is DoD’s own investment in the science and technology so critical to its future needs. During much of the second half of the 20<sup>th</sup> century, the United States was the leader in defense technologies. DoD had a robust research and development program and with its industrial partners, accounted for a significant share of the key new technologies that supported our military capabilities. That is far less true today – again due to a variety of factors.

- The growing importance to DoD of new areas of technology (communications, IT, etc.) – all areas led, and in many cases, dominated by the commercial world.
- Pressure within DoD budgets on S&T spending and similar pressures on Independent Research and Development (IR&D) spending by the aerospace and defense companies.
- The explosion of technology developments and products outside the U.S., especially in regions such as Asia. As a result, technologies that are important to military capabilities are often available to anyone with “deep pockets.”

DoD and its traditional suppliers, have difficulty accessing these robust external sources of advanced technology for various reasons. Some are self-imposed, such as:

- Slow, complicated acquisition processes and complex and onerous rules and requirements, which deter commercial companies.
- A lengthy, convoluted and opaque requirements process that make it difficult for industry to understand future defense needs.
- ‘Buy America’ regulations and other barriers that often exclude foreign suppliers.
- Export Controls (both here and abroad) designed to limit the spread of defense-critical technology that can limit access to U.S. as well as foreign technology.

- Other impediments are more traditional, ranging from inadequate knowledge of what is available in the wider industrial base (here and abroad) and the “not invented here” syndrome.

DoD is concerned by these issues and is addressing them. But support from the Congress for the needed funding and legislative action will also be important.

### **Future Challenges to the Defense Industrial Base**

Looking to the decade ahead and beyond, it is clear that DoD and its industrial partners will face escalating challenges, in part due the likely downward trajectory of DoD spending. This has implications for both DoD’s access to needed industrial capabilities and the makeup of its traditional supplier base. It will also make it more difficult to maintain effective competition as consolidation continues and some firms narrow their focus to businesses where they have comparative advantages.

DoD’s challenges are already obvious:

- Tough decisions to cancel existing weapons programs that may not be affordable in the future.
- Difficult investment choices between traditional platforms and next generation weapons and capabilities.
- Finding adequate funding for investments given the growing spending on military personnel (pay and benefits, retirement programs, and in particular, the rapid rise of healthcare spending).
- Trying to maintain competition when there are only a few (maybe two) providers.

The traditional Defense contractors will also face challenging times exacerbated by reduced defense budgets. Given the concentration of the Industrial Base today, we are unlikely to see the mega mergers and acquisitions we saw in the 1990s. Rather, companies will likely respond in other ways:

- Smaller – often niche – acquisitions to provide new capabilities, contract vehicles and incremental revenue.
- Diversification efforts, which are already in evidence as companies try to penetrate Government markets that are seen as growing or at least stable (e.g. intelligence, CYBER, and Homeland Security). Some limited efforts to expand into commercial markets can also be expected.
- Increased emphasis on international sales, despite the constraints of export controls (e.g. the recent failed effort to sell combat aircraft to India).

- Selling or spinning out declining or less profitable business areas, leaving a more focused and stable base business.

If the investment budget cuts are deep (as in the 1990s), more draconian actions will be needed, that could include mergers of large primes, or sectors of two companies (e.g. shipbuilders). This may prove unavoidable, but will further reduce competition. The smaller players will have other challenges. Do they sell, refocus on commercial markets, or leave the defense sector entirely? This is already underway as numerous small firms have been acquired by larger companies or, in some cases, gone private with the help of private equity firms.

All segments of the Defense Industrial Base will find it harder to attract and retain a capable workforce in a period of decline and contraction. I will leave this discussion to the expert, Norm Augustine.

### **The Services Sector**

My remarks above have largely focused on the aerospace and defense hardware sector. The Services Sector – roughly half of Defense contract dollars – will also face a range of challenges, some different from those facing manufacturing companies. Services cover a broad range of offerings from complex software and C4ISR technology to routine actions to maintain bases and facilities. It is highly competitive with 70% of the dollar value delivered via task order contracts (ID/IQ, GWAC).

The Services Sector may be impacted less, given that much of their funding is from Operation and Management accounts. They also have capabilities that have readier applications in the commercial world (e.g. CYBER or IT). Also, they can quickly cut costs to maintain profits and cash flow, since they are not burdened by extensive facilities and infrastructures. But, they will be undoubtedly impacted despite these advantages. I can expand on the Services Sector in the discussion period if you have questions.

### **How should DoD Respond to These Challenges?**

Determining how to best respond to these challenges will not be easy as the industrial base is large, complex, and multi-faceted. A variety of selected policies and programs will be needed. The appropriate proper actions for the hardware programs will depend on:

- The industry segment
- The competitive landscape

- The access needed to technology and products

The actions that will be required include:

- Preserving competition for key platforms whenever possible, even though it will be costly in the short term. At a minimum, preserving competition among the major system providers is important (engines, fire control systems, radars, etc.)
- Focused investments to encourage competition in new areas critical to combat effectiveness such as C4ISR or innovative capabilities with great potential, such as unmanned vehicles of all types.
- Use of tools such as Broad Area Announcements (BAAs) and prototyping to provide future options and maintain critical skills in the Industrial Base.

A major strength of the Services Sector is its robust competitive nature, its agility and the continued emergence of new, creative companies. This competitive landscape needs to be maintained. Properly administered task order contract vehicles, careful application of OCI (conflict) rules, and actions to enable non-traditional suppliers to compete will all help.

Conversely, DoD must avoid letting excessive competition damage quality of the services, which can result from an undue focus on low price. Best value must be the key mantra in most cases, especially those involving technology and specialized expertise.

Finally, the health of the Defense Industrial Base must be regularly monitored. This includes its financial condition, access to technology and the state of its human capital. We must not recreate the Defense industrial landscape of the 1990s.

### **Concluding Comments**

I compliment the Committee for addressing these issues. I know DoD is addressing them as well and your interest and support will help the Department cope with the industrial base challenges that lie ahead.

I look forward to responding to your questions and comments.