# Statement of David Berteau, PSC, on the Health of the Defense Industrial Base

**Senate Armed Services Committee**

**April 26, 2022**

Chairman Reed, Ranking Member Inhofe, and Members of the Committee, thank you for the invitation to testify this morning on the vital topic of the defense industrial base (the DIB) and its importance to the success of Department of Defense (DoD) missions.

I speak today on behalf of the Professional Services Council (PSC), our more than 400 member companies, and their hundreds of thousands of employees across the nation. PSC represents the full range and diversity of the government contracting sector, with companies of all sizes, doing all types of work, and serving every cabinet department and agency of the federal government. I also speak on behalf of their government customers, because a key PSC goal is to help the federal government become a smarter customer and a better buyer. The diversity of functions performed and the business size of PSC members gives us unique perspectives on the DIB and on changes in government policies and practices that will lead to better support for DoD's missions and America's security.

I appear before you not just as the head of PSC but also as a person with more than 40 years of experience on these issues from all sides, including two stints inside the Pentagon as well as with industry, at a think tank, in academia, and now in my seventh year at PSC. I have seen what works and what does not.

My statement includes:

- comments on the DoD-industry partnership;
- DIB statistics, including data on recent trends in DoD contract spending; and
- observations on the impacts of the war in Ukraine, of inflation, and of COVID-19.

My statement concludes with some observations and recommendations, focused on priorities and criteria for you to keep in mind as your Committee develops the Fiscal Year 2023 National Defense Authorization Act (FY23 NDAA) and considers programs, policies, and funding that impact the DIB.

## The Vital Partnership of Government and Industry

For centuries, one of America's great national security strengths has been the dynamic partnership of government and the private sector. This partnership is vital in the core meaning of that word: our way of life depend on the continuing success of that partnership.

In DoD, contractors provide a wide range of goods and services to the warfighter and to the components and agencies of the Department. These contractor contributions are essential to maintain national security, and the government benefits from a strong, diversified national interest business base to support its current and emerging requirements.

Based on my long experience, here are some key elements of that partnership. I hope that you can keep these in mind as you move forward to address the challenges we face today and in the future.

***1. Companies and their workers are committed to national security and to support DoD missions across the board.***

From the most recently hired worker to the top of the company, DoD contractors are fully committed to supporting the missions and functions of the department. The partnership works best when DoD works *with* companies to address and solve challenges, not in an "us vs. them" approach, but together as "we."

We witness this commitment to mission over and over. Here are two examples.

- When the COVID-19 pandemic hit in March of 2020, and businesses across America shut down, defense contractors kept working. On the factory floor, maintaining ships at sea, in classified facilities, etc., their workers kept on working. In fact, associations like PSC worked with DoD to provide company workers with the necessary documents to keep going to work. Citing DHS guidance about the essential workforce, the Under Secretary of Defense for Acquisition and Sustainment issued a letter that tens of thousands of contractor workers used to enable them to travel to and work on site when others were shut down.
- During the drawdown in Afghanistan last spring and summer, contractors stayed on the job even as the security committed to them in their contracts disappeared.

***2. The defense industrial base is governed by the economic laws of supply and demand.***

Industry's ability to provide defense-unique goods and services depends entirely on DoD demand. For large parts of the defense industrial base, DoD is the largest—and sometimes the only—customer. When that is the case, the size and economic viability of the industrial base will be determined by how much DoD buys.

Recently, DoD issued a report, entitled: "State of Competition within the Defense Industrial Base,"[1] in response to Executive Order 14036: Promoting Competition in the American Economy.[2] The report criticized defense industry for excessive consolidation but failed to acknowledge the department's own role in that consolidation. For example, the report noted that only 3 prime contractors produce tactical missiles in the U.S. today but failed to note that DoD does not buy enough missiles to keep more companies in business. PSC, in conjunction with the National Defense Industrial Association, produced a short paper that addresses shortcomings of

[1] https://media.defense.gov/2022/Feb/15/2002939087/-1/-1/1/STATE-OF-COMPETITION-WITHIN-THE-DEFENSE-INDUSTRIAL-BASE.PDF
[2] https://www.federalregister.gov/documents/2021/07/14/2021-15069/promoting-competition-in-the-american-economy.

this report, and I would be glad to provide it to the Committee for the record, should you so desire.

In addition, even where there is an opportunity for companies that do business outside of DoD, defense-unique requirements of the government impose costs and constraints that make companies less competitive in the commercial marketplace. From security clearance delays to operating on obsolete data systems to complying with reporting requirements that no commercial company has to face, companies in the defense industrial base are tied inexorably to the DoD market.

Finally, with more than 11 million open jobs across the U.S and only 6 million people looking for work, defense companies are competing for workers who can command higher salaries, without the delays required for security clearances, and with flexibility in work locations and conditions that are hard for contractors to match (often because contracts restrict a company's flexibility in such matters). While there is no accurate way to count, discussions with our member companies lead me to conclude that tens of thousands of vacant billets exist today, and they grow harder to fill with each passing month of economic recovery. Unlike in other economic matters, increased demand is not producing the needed increase in supply. Instead, it is contributing to wage inflation, which I will address in a subsequent section of this statement.

***3. Federal contracting processes are complex, with voluminous regulations, and often reflect competing priorities that are not mutually compatible.***

Government contracting is among the most highly structured and controlled elements of the U.S. economy. It consistently prioritizes compliance more than it rewards results. The contracting process is managed by people who often are unconnected to the benefits from the goods and services delivered by contractors. For example, contracting officers (and other officials) are evaluated by the percentage of contract dollars that are awarded to small businesses, but they are not scored on how well those companies actually perform on the contracts they receive.

***4. Companies have to earn enough to stay in business. They compete for funds with the rest of the commercial marketplace in a global economy.***

No company is entitled to a contract, and they must provide a competitive return on investment for the funds they need to stay in business. Government rules generally dictate payment for work only as or after it is completed. Companies have to fund themselves in advance of government invoice payments, and to obtain those funds, they must provide a competitive rate of return.

***5. The success of contractors depends on their ability to <u>predict</u> the future needs of DoD, to <u>invest</u> resources in being ready to meet those needs when contract bids are solicited, and to <u>maintain</u> the commitments in those bids for the months (or years) that it takes DoD to award the contract.***

DoD awards contracts based on proposals submitted by bidding companies, using criteria specified in advance by the government. Those bids include commitments to technical and operational performance, key personnel, and cost, all frozen at the time the bid is submitted. No matter how long it takes DoD to evaluate those bids, companies are expected (at their own cost) to keep available all the resources in the bid, from technology to workers, at the submitted price, no matter what is happening in the overall economy.

As one member company CEO told me, "I don't need to go to the casino to gamble. I gamble every time I submit a bid on a government contract."

Let me turn now to the dimensions and characteristics of the defense industrial base.

## Defense Industrial Base Statistics

One measure of the defense industrial base is the amount of funds obligated for contracts. In FY21, the most recent full year of data, PSC calculates that DoD contract obligations totaled $408 billion. This amount was roughly equally split between contracts for products ($194 billion) and those for services ($214 billion). Overall, contract obligations were 9% lower in FY21 than in FY20, due largely to a decline in contracts for COVID (including vaccine development) and for support of Afghanistan.

The table below includes contract obligations for FY20 and FY21 (note that overall appropriations, including OCO funds, were nearly identical for both fiscal years).

**DoD Contract Obligations for Products and Services, FY20-FY21**

| Contract Category | FY20 | FY21 |
|---|---|---|
| Products | $220B | $194B |
| Services | $229B | $214B |
| Total | $449B | $408B |

The FY21 decline in contract obligations was the first such decline since FY15, which was at the tail end of the impact from the FY13 sequestration of DoD funds. This trend may reflect a one-time decline; preliminary first quarter FY22 contract obligations are slightly higher than for the same quarter in FY21, even though funding under Continuing Resolutions was at the same level as in FY21. With the enactment of FY22 appropriations, we expect later this year to see increases in FY22 contract obligations commensurate with the increase on DoD authorizations and appropriations.

### *Declining Numbers of Prime Contractors*

Another measure of the DIB is the number of companies that participate as prime contractors or subcontractors. A recent report from the Center for Strategic and International Studies[3] cited the drop in overall numbers of companies with one or more prime contracts from DoD, from more than 60,000 in 2009 to roughly 41,000 in 2020. Experience tells us, though, that those numbers alone are not the full story.

[3] https://csis-website-prod.s3.amazonaws.com/s3fs-public/publication/220329_Sanders_DefenseAcquisitionTrends_2021_0.pdf?n_gpAQf5972Vi6KlWfAS4mN9iOrK1CIh.

The vast majority of those companies (more than 25,000 in 2020) are small businesses, and their contracts are frequently awarded through various programs that "set aside" awards only for eligible small businesses.  This does help keep small businesses going, until they outgrow their eligibility for those "set-aside" contracts.  PSC analysis shows that once such companies "graduate" from small-business status, their success in winning DoD contracts drops precipitously.  In other words, DoD and federal small business policies and practices punish growth rather than rewarding it.  This is not the way to attract more companies to do business with DoD.

What happens to small businesses that graduate?  They become mid-sized companies instead of small ones, and the same CSIS study shows that the decline in mid-sized businesses is roughly the same as for small businesses.  Even large companies are fewer in number than at the peak in 2009.

In addition, neither the CSIS report nor any publicly-available data from DoD tells us the actual number of contracts.  It is my belief, based on anecdotal evidence, that two dynamics are at play here.

One is that DoD may be awarding fewer contracts overall.  There is inconsistency in counting and reporting contracts into the publicly-available data, which makes it hard to compare from year to year.  In addition, classified contracts are not part of that data (and are excluded from the CSIS report and from PSC's own analysis).

The second is that DoD contracts are often awarded to companies eligible under a set of contracts known as GWACs, or government-wide acquisition contracts.  Many of these contracts limit the number of companies eligible to receive awards and offer few opportunities for new companies to gain a spot on any given GWAC.  This makes the job of the contracting officer easier but does little to increase the number of bidders.

Why has this happened, and what does it mean?  How many companies does DoD need in the industrial base?  While beyond the scope of this hearing, more analysis could be valuable here, but there are two other elements of the defense industrial base that may matter more.

***Subcontractors***

Neither DoD nor any other agency tracks the number of subcontractors.  DoD estimated in 2019 that up to 300,000 companies performed subcontract work for DoD in areas that would be covered by cybersecurity requirements.  No one knows whether or to what extent the companies that no longer receive prime contracts are still in the defense industrial base as subcontractors. Efforts to increase supply chain resiliency will rely on layers of subcontractors, yet DoD knows little about these companies and even less about what makes doing business with DoD more attractive.

### *Non-traditional Contracts*

In addition, DoD has increasingly turned to Other Transaction Authority, or OTA, for work done by the industrial base. Such work is under an OT agreement, not a contract, and is not captured in the data. No one knows the extent to which work under such agreements offset the apparent decline in the overall number of companies.

## The Real Question

The real question is what policies and regulations are needed so that the defense industrial base can meet national security needs, today and in the future.

To help answer that question, let's look at three specific challenges.

### *Impacts of Ukraine*

Even before Russia invaded Ukraine on February 24, 2022, DoD was drawing down stocks of weapon systems and supplies and providing them to Ukrainian forces. The pace of that support continues to increase, with the president announcing additional support last week and preparing to ask Congress to authorize more. The nature and purposes of such support is evolving and will continue to change, which makes analysis complicated.

Three big questions arise for industry:

1) How will depleted stocks be replenished or replaced?
2) What else will be needed?
3) Who pays for this?

Public reports indicate, for example, that fully one third of the available stock of Javelin anti-tank weapons have already been drawn down for Ukraine, in barely two months. It's apparent that stocks will not last for long at that pace, and to the best of my knowledge, no contracts have been awarded for replenishment of any items being supplied to Ukraine or to allies to replace their own contributions to Ukraine.

What else will be needed? That information is not broadly available to industry today, although some programs have begun discussions with some companies. Who will pay for the up-front costs of increasing production capacity or even reopening closed production lines? As of now, there is no line item for such funding and no proposal that I have seen. Indeed, thanks to delays in submitting budget justification material coupled with the submission of Unfunded Priority Lists from DoD components, as I write this, we know more about what is NOT in the FY23 budget than the details of what IS in it.

DoD did, however, issue a Request for Information (RFI) last week for "Weapons Systems or Commercial Capabilities for Ukraine Security Assistance," with responses due May 6. This is a step, albeit belated, in the right direction, but it seems apparent that it may be easier to deplete stocks of weapon systems and munitions than it is to restore them.

This is not a new problem. We saw it during my last tour in DoD, where the use rate for certain munitions (HARM missiles, for instance) was far in excess of current production capacity to replace them, and the lead time for increasing production was years, not months. I am not privy to current assessments, but it is likely that today's supply chain constraints have made those time lines longer, not shorter.

***Workforce and Replenishment***

In addition, replenishment faces a problem today that did not exist in 2015 for Afghanistan or the counter-ISIS campaign, and that is a shortage of workers for nearly every defense contractor. My statement already covered this issue more broadly, but if action is not taken soon, this shortage of workers will diminish industry's ability to respond to the increased demands resulting from Ukraine assistance.

The impact of inflation on supplies, components, energy, and wages further complicates the issues of replenishment. Let me turn now from Ukraine to that second challenge.

***Impacts of Inflation***

There are three separate challenges with the return of higher rates of inflation: wage and price inflation today, recovering cost increases on existing contracts, and addressing possible inflation shortfalls in the FY23 DoD budget proposal.

***1) Wage and Price Inflation***

Defense companies are in a bind. Existing contracts, whether of a fixed-price or cost-reimbursable nature, offer little room for them to recover the increased costs from wage inflation or the increase in prices for material and components, including energy and transportation. Because inflation has been so low and stable for so long, fewer existing contracts include what's known as an EPA, a clause that permits Economic Price Adjustments. Absent such a clause, contractors have a harder time making the case for DoD to cover their increased costs. However, even with such a clause, programs may claim that they don't have the funds to cover these increased costs.

This is particularly a problem for companies providing services. Such contracts are often so competitive that margins for successful bidders are in the low single digits. A company that realizes a 4% or 5% fee on a contract simply cannot absorb the wage cost growth of 8% or 10% that we are seeing today.

DoD's public response to this has been to note that, to date, it has received few requests for equitable adjustments, known as REAs. While that may be true at this time, this does not mean there is no problem. Rather, companies faced with uncompensated cost growth must first document the situation and discuss it with their program office before submitting an REA.

In addition, the REA process requires companies to submit requests rapidly, often within 30 days of incurring the unanticipated cost, but there is no timeline for the government to respond to those requests. I have seen DoD take a year or more to reach a decision on an REA, and even then only a part (or none) of the costs are paid.

Finally, the breadth of the inflation problem cannot be addressed one contract at a time, which is the preferred approach of the current policy. We need a faster way to deal with this. PSC believes that DoD should issue broad agency-wide guidance that reminds programs and contracting officers of their affirmative responsibility to maintain the long-term viability of the industrial base and to increase the flexibility that programs have to cover such cost growth.

***2) Existing Contracts and Availability of FY22 Funds***

Even though DoD's FY22 appropriations was signed by the president just over a month ago, its funding levels did not provide for coverage of 8% inflation. If I were still in DoD, rather than saying that we don't yet see a problem because few requests have been received, I would try to get in front of this problem by estimating the additional funding needed to cover this cost growth and looking at ways to meet those costs. Perhaps DoD is doing that, but to date we have seen no requests for the information they would need for such estimates. Absent action, this problem will get worse. Companies that cannot recover their costs will not be able to stay in business for long.

***3) FY23 Inflation***

DoD in testimony before this Committee has already undertaken to explain their approach to inflation estimates in the FY23 budget. While this is a real challenge both for DoD and for this Committee, it is important to recognize that addressing inflation in FY23 will not fix the current problems.

***Impacts of COVID-19***

The third challenge facing the defense industrial base includes the impacts of COVID-19. As I mentioned previously, defense industry stepped up from day one of the pandemic. Companies kept going as the rest of business shut down. They provided for the health and safety of their workers and their families and households, including testing and vaccinations as well as changes to workplaces. The cost for these provisions were not recoverable under existing contracts and in many cases were completely absorbed by the companies themselves.

One action taken by Congress was significantly beneficial. Known as Section 3610 (because that was the section number of the 2020 CARES Act provision), it provided the authority for agencies (subject to the availability of funds) to reimburse companies for retaining essential workers even when COVID-19 prevented them from accessing workplaces. Tens of thousands of workers were retained as a result of this provision, at no additional cost to the taxpayers. The intelligence community and civilian agencies also used the same authority.

That authority, unfortunately, has been allowed to expire. Last year, this Committee considered but ultimately did not include language that would have provided such authority on a stand-by basis, making it available for DoD to use if needed.  PSC urges the Committee to take another look at such language and include it in the FY23 NDAA.

In addition, executive branch actions regarding COVID-19 continue to impact the ability of industrial base companies to meet the requirements of their contracts and to hire and retain necessary workers.  While the contractor vaccine mandate in unenforceable under a federal district court injunction, the FAR clause remains in effect.  Were the injunction to be revised or reversed, that clause would be immediately effective.  Every government contractor worries about what that would mean for their workers and their contracts.  No company can tell a prospective employee what the requirements might be in the future.

An additional complication arises under COVID-19 with regard to access to facilities.  Unlike the enjoined FAR clause, which applies government-wide, the requirements for access to government facilities is completely decentralized to each facility and often to individual offices within a facility.  On any given day, a company's worker can face changes in requirements for vaccination status, attestation, or proof.  Masking requirements are dictated by the COVID risk designation of the county as reported by the CDC to be low, medium, or high.  For now, few counties are medium or high, but that can change rapidly and without advance notice.  All of this makes it hard for companies to know whether their employees and subcontractors will be able to access their workplaces.

I am not suggesting that this needs a legislative fix, but I am suggesting that it makes it harder for companies to manage their workforce and to meet the needs of their DoD customers.  To date, there has been no coordinated action to address this complex challenge.

## Additional Observations and Recommendations

PSC offers the Committee a number of additional proposals for consideration in the FY23 National Defense Authorization Act that could support the ability of the defense industrial base to meet DoD's needs, including:

### *1) Reinforce real competition where it can thrive.*

Half of DoD contract dollars go to services, and what was once a product is often now procured as a service.  From data storage to satellite launches, DoD does not need ownership to benefit. This $200+ billion services market offers unrealized potential for DoD.  For example, 70 percent of DoD system costs are in life-cycle support, sustainment and operations, yet there are too few opportunities for real competition.

This is in part due to the lack of transparency surrounding the long term  needs of the Department. Requiring DoD to provide Congress with additional, publicly available information would benefit DoD and the industrial base.  Accordingly, PSC recommends that Congress require DoD to include in Operations and Maintenance (O&M) budget justification documents an unclassified budget display for the total amount projected for each subactivity group for the future-years defense program.  I will tell you that, when I was the Assistant Secretary of Defense for Logistics, this information would have helped me do my job, and if Congress had required it, I would have had it for internal use as well.

In addition, excessive focus on low bids reduces real competition. Past legislation by this Committee required DoD to use Low Price Technically Acceptable (LPTA) contracts only when clearly justified, but reports from our member companies indicate a lack of compliance with the statute in this area.

Finally, DoD should emphasize competing on results rather than price. This would support innovation, encourage improvements in systems and processes, creates jobs, and better meet warfighter needs.

***2) Reduce Procurement Administrative Lead Times (PALT).***

Long procurement administrative lead times can prevent the government from accessing the solutions it needs when it needs them and can limit the participation of companies in the defense industrial base. The FY18 NDAA required DoD to measure and track PALT with a goal of reducing lead times, but we believe PALT is increasing. Reducing PALT should be a priority for the government to improve acquisition timelines and also to attract and retain innovative companies. PSC believes this Committee can call attention to DoD's need to implement that FY18 language.

## Conclusion

There are a number of additional challenges that merit attention, and I would be happy to discuss any or all of them during this hearing. In closing, though, and on behalf of PSC and our members, I thank you for your time and consideration of these matters. As always, PSC is available at your convenience to address any questions or concerns the Committee has, now and in the future. I will try to answer any questions you may have, and I look forward to continuing to work with the Committee on all of these important industrial base challenges.