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The Dwight D. Eisenhower School for National Security and Resource Strategy

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PRIVATE SECTOR SUPPORT & SERVICES 2014

ABSTRACT: The Eisenhower School Private Sector Support Services (PS3) Industry Seminar analyzed the services companies that support the US Defense Department. Over the past twelve years of war, with both increasing defense budgets and augmented Overseas Contingency Operations (OCO) funding, the Department of Defense (DoD) saw the expansion and evolution of the Defense Services Industrial Base. Today, contractors have become an integral part of the Total Force structure. As such, we recommend efforts to fuse services into future strategic-level and Operational Contract Support planning be supported. Increasingly, these support services are not only considered mission critical within the kinetic and non-kinetic battle-spaces, but the execution of these services can now significantly impact many of the predetermined levels of success for achieving the national security interests, both domestically and abroad. At no other time in our nation's history has Private Sector Support and Services (PS3) played such a pronounced role than during the period spanning 2002 to 2014. Unfortunately, the fiscal environment has changed significantly in recent years. While this period of conflict has highlighted the operational impacts and contributions of the companies that support the DoD, it has also heightened the awareness of senior leaders and members of Congress regarding both the costs and the acquisition procurement methods associated with contracting for these services.

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PLACES VISITED

Domestic:
National Capital Region
BAE Systems
DynCorp International, LLC
Eisenhower School Seminar:
- Airbus Group
- Alston & Bird LLP Law Firm, Legislative & Public Policy Group
- Air Force Services Acquisition PEO
- PAE
- Professional Services Council
- SIGAR

G3S International Training, Inc
Fluor Government Group
ITT Exelis
Lockheed Martin
NCI Information Systems, Inc
Office of Management & Budget
SERCO, Inc
USD AT&L
US Department of State

Tampa, Florida:
U.S. Central Command
U.S. Special Operations Command

New York, New York:
Goldman Sachs
J.F. Lehman & Company
Thundercat Technology

Foreign:
Paris, France
Bollore Africa Logistics
Central du Service due Commissariat des Armees (SCA) Ministere de la Defense
Economat Des Armees
Sodexo

London, England
Airbus Group U.K.
King's College London
U.K. Ministry of Defense

INTRODUCTION

A Short History of Private Services Support

America's addiction to the Eisenhower coined "military-industrial complex" is no secret. George F. Kennan, the father of our Cold War containment policy, publicly acknowledged this addiction during a lecture he delivered to Grinnell College in 1984.[1] In this speech, Kennan, reflected on the "extreme militarization not only of our thought but of our lives" insinuating, according to Vanity Fair's Todd Purdum, that feeding the military-industrial complex had become our "national addiction."[2]

Perhaps what, until recently, had remained secret was the burgeoning love affair in the services industry that has dominated this 700 billion-dollar military-industrial complex in the post 9/11 contingency environment. As with any love affair, once the relationship is public it faces great scrutiny. Often devastating for all parties involved, the challenge is in the recovery. What remains to be seen is whether the affair between the government and the private sector is one that will stand the test of time, or falter under the pressure and scrutiny of discovery.

The Beginning…

Some argue that the seemingly unprecedented level that government and military services are currently outsourced is most certainly linked to a Republican supported, Bush-led agenda to funnel money to large corporations supportive of his administration. These arguments are not only naïve, but historically inaccurate as well. The roots of the private-public partnership, particularly within the services industry, run much deeper. In fact, it transcends political parties and pre-dates the Bush administration by more than two centuries.[3]

Recognizing the importance of the private-public partnership in the earliest phase of American history, the Continental Congress approved Letters of Marque and Reprisal, granting permission for privateers to attack flags of enemy nations during the Revolutionary War. In his piece which sought to highlight the importance of these maritime endeavors in securing and maintaining American's independence, Edgar Maclay wrote in 1889 that, "the history of the United States navy is so intimately connected with that of our privateers that the story of one would be incomplete without a full record of the other."[4]

An Illustration – George Washington & Privatized Intelligence Services

It was during this same period that the secret romance between government and privatively procured intelligence began. George Washington, nicknamed by the CIA as the "first Director of Central Intelligence," contracted with businessmen and merchants to develop a sophisticated network of spies charged with reporting on the activities of the British.[5] The value of this intelligence partnership is well illustrated in a quote from a former British Officer regarding the American Revolution. It reads, "The Americans did not outfight us, they out spied us." [6] Ensuing Presidents continued this tradition, as highlighted by the relationship established by President Lincoln with a private intelligence company still in business today.

Glasgow born Allan Pinkerton immigrated to the United States in 1842 and discovered he had a pension for detecting nefarious activity. After serving a short stint in public service as a sheriff in Chicago, he established his own detective agency in 1850, the Pinkerton National Detective Agency. Recognizing that Pinkerton's agency had investigative talents that the U.S. government lacked, President Lincoln contracted him to conduct a number of intelligence related tasks. Most notably, he uncovered a plot to assassinate the President in Baltimore in 1861. Additional tasks contracted included leading U.S. counterintelligence efforts and establishing a ring of spies to gather wartime intelligence against the Confederates.[7] Still in existence today as a subsidiary of the Swedish security company Securitas AB, the company advertises a portfolio that includes a spectrum of services including investigative services, intelligence services, and crisis management. On the modern day Pinkerton website, they boast they are "the industry leader in risk management since 1850."[8] As of 2008, Securitas claimed 250,000 employees and 12 percent of the global market in outsourced security services.[9]

The Middle…

The Cold War era propelled the outsourcing of services ahead by light years.[10] In the same year that American troops arrived in Vietnam, public scholars began lauding the "virtues of the 'fusion of economic and political power'. This fusion, they predicted, would limit the growth of the federal bureaucracy.[11] Within two years, the Bureau of the Budget directed that the federal government consider outsourcing activities if it would economize taxpayer dollars.[12] The movement to privatize services continued throughout the cold war, and intensified under President Reagan who sought to reduce the government footprint and eliminate inefficiencies.[13] As pressure mounted to limit civil service personnel, greater attention to the private sector's ability operate in lieu of bureaucratic institutions was underway.

The arrival of President Clinton brought drastic cuts to the federal workforce. Coming off the heels of the end of the Cold War and the "Peace Dividend", the appreciation of and need for a robust intelligence community diminished significantly. President Clinton's National Performance Review (NPR) brought about recommendations to consolidate functions across the federal workforce, reduce the overall size and outsource a number of government services.[14] Under the NPR, 203,300 government positions were ordered cut. This in turn forced many government agencies to turn towards outsourcing of services in an effort to avoid busting personnel ceilings mandated under the review. In his work on intelligence outsourcing, Jacob Gale writes that the, "total procurement at the close of the Clinton Administration—nearly $219 billion—exceeded that at the beginning by $18 billion, an increase of $34 billion over the previous decade."[15] After 9/11, Defense spending soared, and with it, the use of contractors to provide services, particularly overseas, often side by side with deployed soldiers, sailors, and marines. Figure 1 below illustrates the dramatic rise of contractor support during the war years, when, at various points of time, contractors exceeded the numbers of military members.

Figure 1

With the sting of the global financial crisis still fresh and revelations of outlandish government spending making headlines repeatedly, it is no wonder that scrutiny of government spending, and in particular that spent on contracting support, seems to be the topic *du jour*. Numerous commissions established to provide transparency and evaluate the effectiveness of the money spent on contract support are now in force. Given the complexities of the environment in which these contracts are undertaken and executed, it is not surprising that findings have shown that a proportion of the money spent was lost to contract waste and fraud.[16]

The conflicts in Iraq and Afghanistan have exposed the increasing demands placed on military and interagency acquisition and contracting systems, command and control arrangements, readiness requirements, and daily operations. Areas of doctrine, policy, organization, culture, as well as both interagency and coalition coordination have simply not kept up. Recent activities of some contractors in the wars and supporting stateside activities, particularly private security and intelligence personnel, also demonstrate that neither U.S. nor international legal regimes have kept pace with the realities of contractors on the battlefield or in the office spaces.

The End? This paper examines the changing strategic and economic environment within the DoD, actions taken by industry in reaction to the changing environment and provides recommendations on how to meet the future challenges facing government agencies, and an assessment of the viability of the private sector companies who contract with the DoD.

PRIVATE SECTOR SUPPORT SERVICES (PS3) DEFINED

For the purposes of this paper, the PS3 universe is composed of the firms and markets providing contracted services and support to the DoD and other government agencies both domestic and abroad. These companies span the gamut of industries: Logistical support, Information Technology (IT)/cyber, health services, installation support/base operations support (BOS), translators, interpreters and linguists, engineer services and construction, training, intelligence, surveillance and reconnaissance (ISR) support, and private security contractors (PSC). All are bound by one common theme – they do business with the U.S government.

UNDERSTANDING THE CHANGING OPERATIONAL & ECONOMIC ENVIRONMENT

"There is no instance of a country having benefited from prolonged warfare." – Sun Tzu

A number of far-reaching and significant changes in the US economic and defense environment will impact stakeholders across the PS3 community and the DoD. To better understand the behaviors, perceptions and anxieties of the private sector service companies doing business with the DoD, it is necessary first to understand the underlying forces that influence the operational and economic environment. The PS3 industry seminar focused on three major changes – the end of combat operations in Afghanistan and a return to a pre-9/11 defensive, limited engagement posture, the ongoing defense budget contraction with the consequent reduction in funding, and the burgeoning realignment to new defense priorities, particularly the Cyber Security arena.

From War to Peace

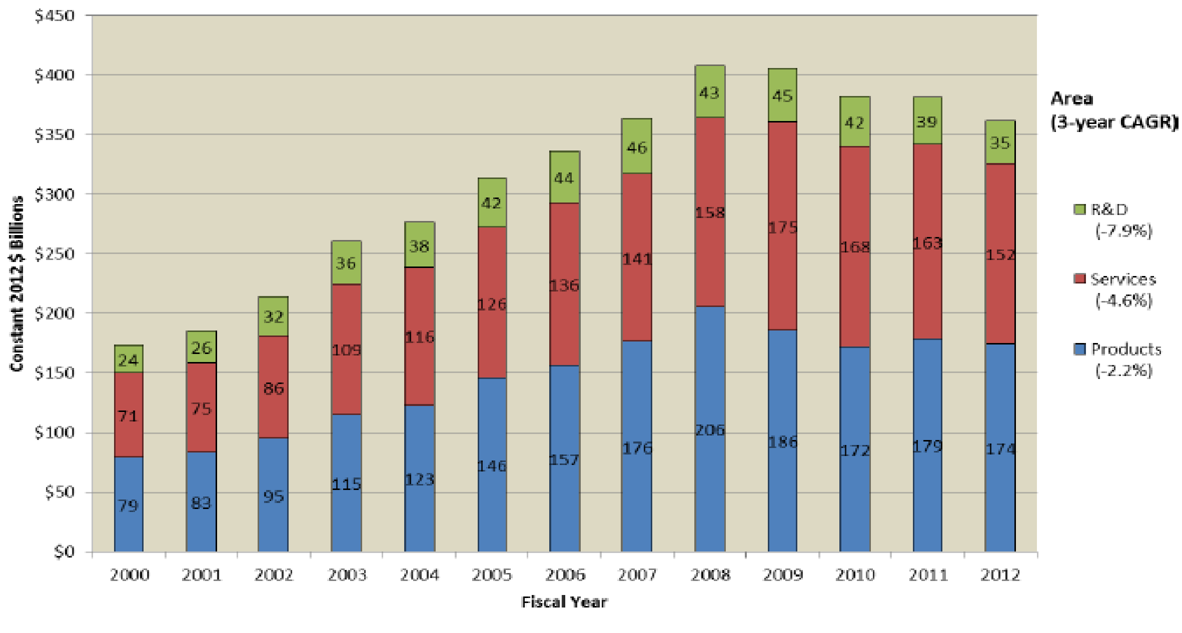
> *We are strengthening our military to ensure that it can prevail in today's wars; to prevent and deter threats against the United States, its interests, and our allies and partners; and prepare to defend the United States in a wide range of contingencies against state and nonstate actors.* ***We will continue to rebalance our military capabilities to excel at counterterrorism, counterinsurgency, stability operations and meeting increasingly sophisticated security threats****, while ensuring our force is ready to address the full range of military operations. - The 2010 National Security Strategy*[17]

The key phrase in this passage in the National Security Strategy is the *continued rebalance of our military capabilities*. Today the DoD is engaged in a gradual transition from a department engaged in two simultaneous wars plus a global war on terrorism, to one of sustainment and focus on future contingencies. Data from the Balkans, Afghanistan, and Iraq indicate contractor support represented over half the total force engaged in these contingencies.[18] This shift across recent conflicts represents the growing trend of DoD's reliance on contractor support in expeditionary operations. However, the composition of support provided in a conflict differs greatly from that of peacetime sustainment contractor support. In 2012, 49% of all DoD obligations were for goods, 41% for services, and 10% for research and development. By contrast, in Afghanistan, 80% of contract obligations were for services, 16% for goods and 5% for research and development. This data suggests that the private sector service industry must be service-centric during contingency operations, but more balanced between products, services, and research and development in noncombat sustainment operations. The changing environment initiated by the drawdown is likely to continue during the current fiscally austere environment. As such, an understanding the budget landscape is critical.

The Decline in Services Spending

Since the end of the war in Iraq and throughout the gradual withdrawal of personnel from Afghanistan, the DoD anticipated a dramatic reduction in operating funds. Overseas Contingency Operations (OCO) funding is declining and the service components are relying on discretionary funds to maintain defense capabilities. In 2010 then Secretary Gates argued for a 30% reduction in funding for service support contractors over a three-year span. Absent specific guidance on areas in which to reduce private contract expenses, the individual military services undertook initiatives to relook at the mechanisms to procure goods and services with an increased emphasis on fixed price contracts, reduced overhead, and gained efficiencies.[19]

The Center for Strategic and International Studies published a report in 2013 that analyzed DoD contracting trends between 2000 and 2012. The report supports the generalization that DoD service contract obligations have steadily declined since 2010. According to the report, DOD outlays for contract obligations in 2012 were at 55% of total expenditures, well below the 70% peak in 2010, but still above levels prior to 2005.[20] As expected, the greatest decline among services was in Army contract service obligations reflecting the drawdowns in both Iraq and Afghanistan. The only branch experiencing an increase in service contract outlays was the Air Force, with a 5% increase between 2011 and 2012 due to an increase in fixed price research and development spending.[21] As a share of total DoD outlays in 2012, contracts for services experienced the sharpest decline from a peak of 37% to 29%, whereas obligations for products



Source: FPDS; CSIS analysis.

Figure 2

only declined by 2% (Figure 2).[22]

In 2014, DoD requested $607 billion in total appropriations; within that number, $527 billion funded "base" programs constituting normal, day-to-day activities across the six appropriation areas and $79 billion requested to pay for OCO.[23]

The primary dilemma for defense leaders is that while the FYDP projections rise slightly and the associated costs within various appropriations areas increase, the expected available

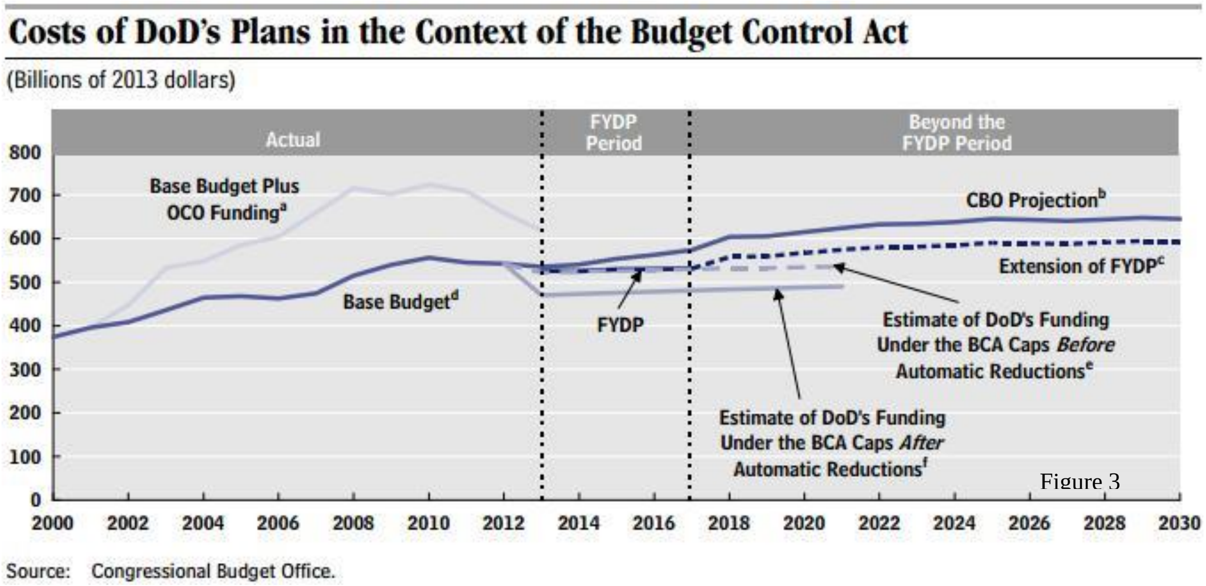


Figure 3

budget shows a significant decline. This is particularly so if, as we expect, the spending constraints of the Budget Control Act and its 2012 amendment are not repealed. In general, the projections tell us that for the foreseeable future DoD costs will rise steadily over time and the divergence between escalating costs and shrinking budgets place significant pressure on the DoD to make dramatic across the board cuts. The Congressional Budget Office (CBO) estimates the DoD funding gap will be between $60 billion and $90 billion per year throughout the FYDP and beyond to 2030. To offset this significant delta, DoD will need to make sharp cuts and find efficiencies by reducing the size of its forces, scaling back the development and purchase of weapons, and/or reducing operations and training expenses.[24] The CBO projections in figure 3 below illustrate the grim realities of the BCA and follow on sequester.

Another concern for future budget squeezes comes from the specter of increased interest payments on America's rising national debt coupled with the expected rise in mandatory entitlement spending. Without any changes to the mandatory spending programs, economists expect the payments to squeeze discretionary program funding well into the future. With the majority of discretionary spending earmarked for Defense, many economists believe the DoD will bear the brunt of future discretionary budget cuts, which translates to a much longer decline in defense budget spending.[25] A look at the current CBO projections (Figure 4) provides a grim view of the nation's financial future, with budget deficits growing each year through 2022.

The uncertainty involved in the future budget cuts hits the services sector particularly hard as well. As the DoD struggles to find efficiencies in areas like base operations support, cuts in the services sector will likely occur. While current contracts continue,

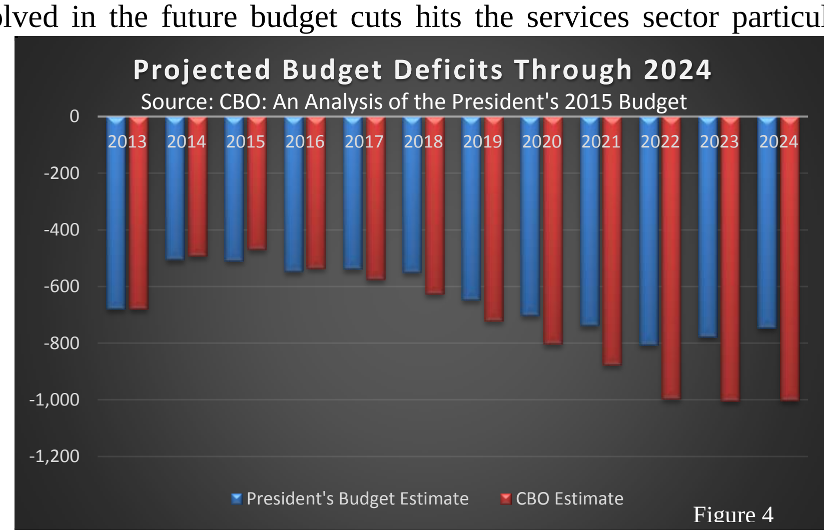


Figure 4

firms providing services are bracing for change resulting in significant churn across the services industry. If firm consolidation is imminent, given the decline in required services as operations in Afghanistan terminate, the question remains as to whether the industry will sustain the capacity and capability needed across the services arena to support DoD requirements.

A Shift to New Threats/National Priorities –Cyber Security

While budget concerns have put pressure on all areas of government spending, there is still a positive outlook for firms operating in the Cyber and IT industry. Within the defense, intelligence, and homeland security budgets, it is expected that there will be focused levels of priority spending, driven by growing needs for sophisticated intelligence gathering, secure information sharing, and programs that counter anti-access and area-denial capabilities. Thus, it is likely the industry will experience sustained levels of funding in the areas of integrated electronic warfare, networked communications, intelligence, information analysis, cyber-security and health care.[26] Overall analysis shows that these industry sectors have healthy competition among the companies; there is relatively stable demand, and the ongoing need for PS3 providers to support customers with information and technical services in both the domestic and global government sectors. The chart below (Figure 5) from a White House briefing in 2013 illustrates that while overall IT budgets for DoD are trending slightly downward, the total reduction is less than 3% from 2012 to 2013. In fact, several agencies show a rise in Cyber Security spending.[27]

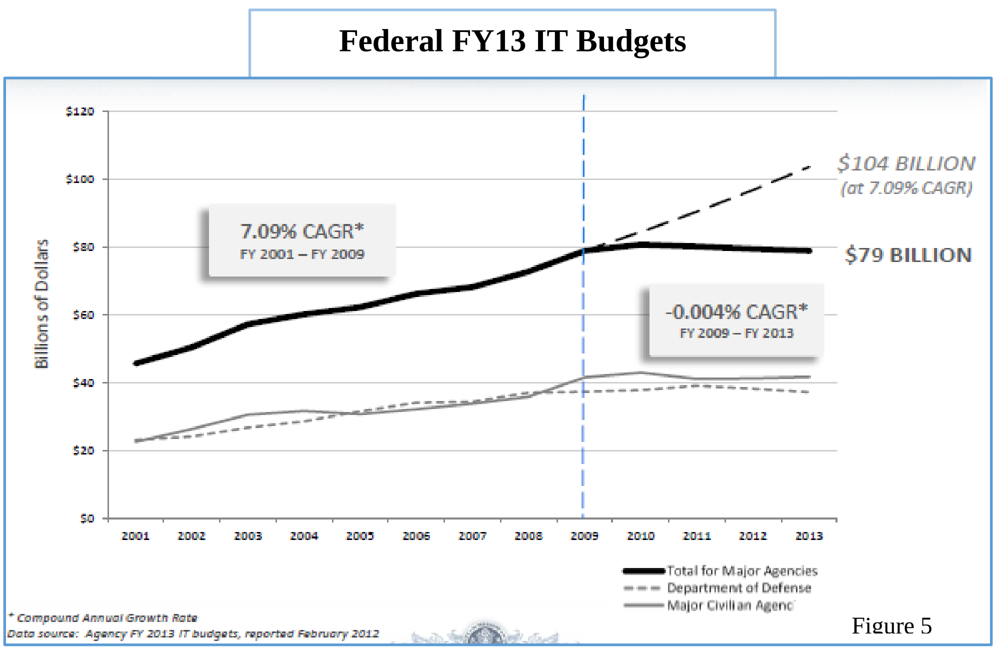


Figure 5

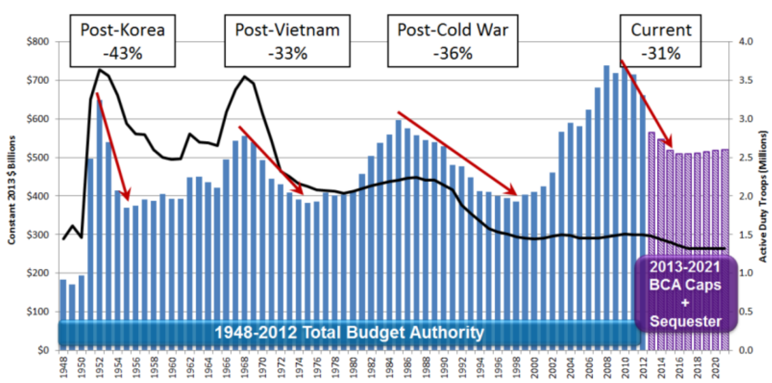
ANALYZING THE IMPACTS OF A CHANGING ENVIRONMENT

The coming drawdown in defense budgets and capabilities is not a new phenomenon. A review of past drawdowns starting at 1948 shows a predictable cyclical pattern to defense spending. Following the collapse of the Soviet Union and the subsequent end of the Cold War in the 1990s, the United States implemented significant defense budget reductions lasting until the terrorist attacks on September 11, 2001. As in the nineties, America finds itself once again implementing steep defense budget cuts as the wars in Iraq and Afghanistan draw to a close.

From the Cold War to Today – the Cyclical DoD Budget

For defense service providers facing today's austere budget environment, it is helps to study and apply lessons learned from corporate actions taken during the last drawdown to gain valuable insight into how companies survived that period. To demonstrate why businesses today can apply similar lessons from the nineties, an analysis of the previous drawdown identifies the major similarities and differences between the two periods. To start, the strategic environments between the two periods are very much alike - long periods of large defense budget increases due to "wars" followed by the cessation of conflict and the subsequent need to downsize the military and reduce spending. The chart to the left (Figure 6) illustrates the severity of both drawdowns. Another similarity is the resulting loss of jobs due to military contractor downsizing. The United States saw the loss of tens of thousands of jobs due to the defense sector's downsizing in the nineties, and America could again witness the loss of tens of thousands more in the next couple of years.[28]

Historical U.S. Postwar Budgetary Trends



Source: White Hollow International Studies Figure 6

One potential consequence of a drawdown is the drive for corporate consolidation within the defense industry. In the nineties, the defense industry focused on consolidation, starting with what many describe as the "Last Supper" in 1993, where the Secretary of Defense projected fewer than half of the existing defense firms would survive the upcoming defense budget cuts.[29] This set off a wave of consolidation within the industry, resulting in sixteen American-based prime contractors dwindling to six. By 2000, the top ten firms in the industry accounted for 60 percent of the market.[30] Today, though it likely will not be the same magnitude, several defense service company executives are expecting similar behavior within the industry.[31]

The Impact of the Drawdown on PS3 Companies

The last drawdown primarily affected large defense manufacturers; however, industry analysts expect this cycle to have more of an impact on the defense service providers. *Bloomberg Magazine's* 2014 Government Business Outlook stated that within the announced DoD manpower reductions, defense services companies "…that provide a variety of goods and services, from construction to food services and information technology, will also feel the pinch."[32] Additionally, the *FTI Journal* claimed, "…defense contractors likely will bear the brunt of the new normal…" due to the administration's desire to prevent base closures and personnel cuts.[33] Second, the rate of decline will be faster in the current drawdown for two reasons: the severity of defense cuts (almost $487 billion over ten years) and the looming specter of $500 billion in sequestration cuts (although currently on hold for the next two years).[34]

Finally, to survive, businesses are shedding or spinning off companies to focus on their core functions rather than acquiring companies, as was more common in the nineties.[35] Ms. Censer of the Washington Post explains, "Rather than the mass consolidation of the largest contractors that occurred two decades ago, observers expect more rearranging of parts and consolidation at lower levels, particularly among the service companies that have proliferated over the past decade."[36] One tool to analyze the impact of the changing budgetary environment on DoD and PS3 companies is Porter's Five Forces Analysis which looks at rivalry among competitors, the bargaining power of suppliers and buyers, the threat of new entrants and the threat of substitute services.

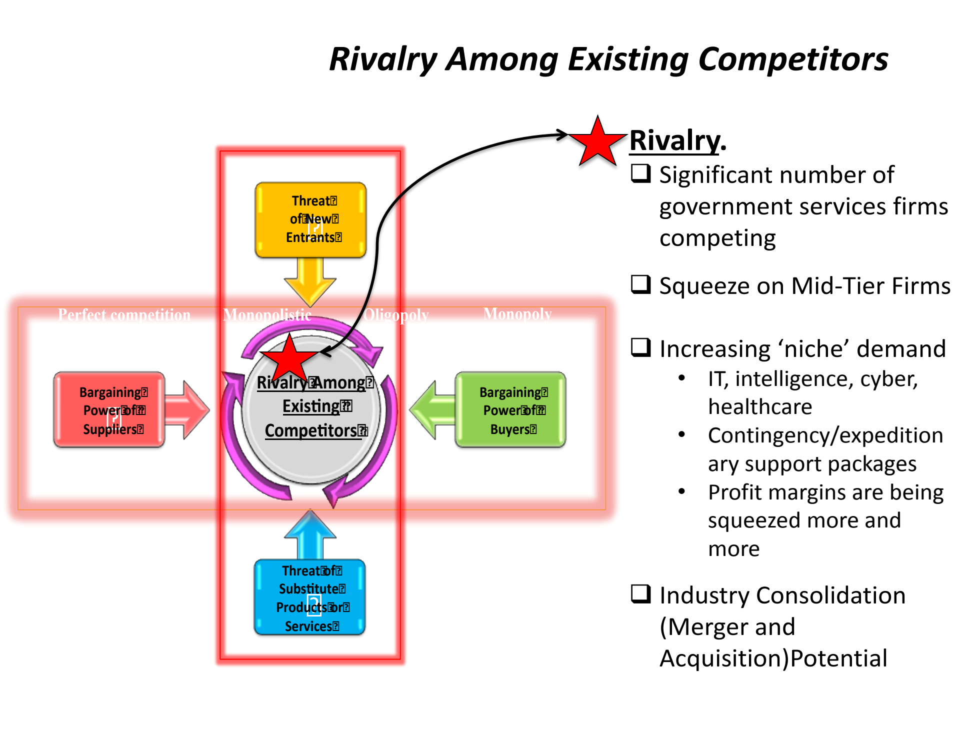


Figure 7

Five Forces Analysis – Rivalry Among Competitors

The PS3 Industry team analyzed the impact of this challenging environment on the small, mid-tier and large companies that make up the services sector. In this graphic (Figure 7), the seminar looked at the high level of rivalry amongst the various firms providing services to the government. We concluded that rivalry is brisk due to the significant number of services firms competing against each other, many of which proliferated during the lengthy Iraq and Afghanistan wars. Our analysis found that significant competition exists among very large firms with wide variations of capability and large pools of resources. This is putting competitive pressure on mid-tier firms with limited resources and infrastructure. Another factor working against mid-tier companies is the prescribed use of small businesses, who have a certain amount of business "set aside" for them by the government buyers. Our interviews and discussions with PS3 firms revealed the companies are looking for the potential market niche areas where the government is focusing its resources, particularly in IT, intelligence, cyber, and healthcare. Our analysis also points to increased industry consolidation as the pool of available work shrinks and competitive differentiation decreases.

Five Forces Analysis - The Power of the Buyer (DoD)

Within the Five Forces model, we determined that the constrained budget is a key driver behind the changes within the industry. Government acted to reduce uncertainty, particularly through passage of the newest budget agreement; the Bi-Partisan Budget Act (BBA). This act improved clarity for industry and reduced some of the financial impacts of sequestration but challenges remain with realistic program prioritization and the ongoing BCA implementation after 2015. We also noted a degradation in government and Industry relations revealed through our face-to-face meetings with industry personnel. One of the causes of this communication barrier may be the shortage of Contracting Officers and buyers resulting in less time to meet regularly with industry. This comes at a time when it is critical for firms in the industry to build relationships with their government customers so they fully understand the government requirements.

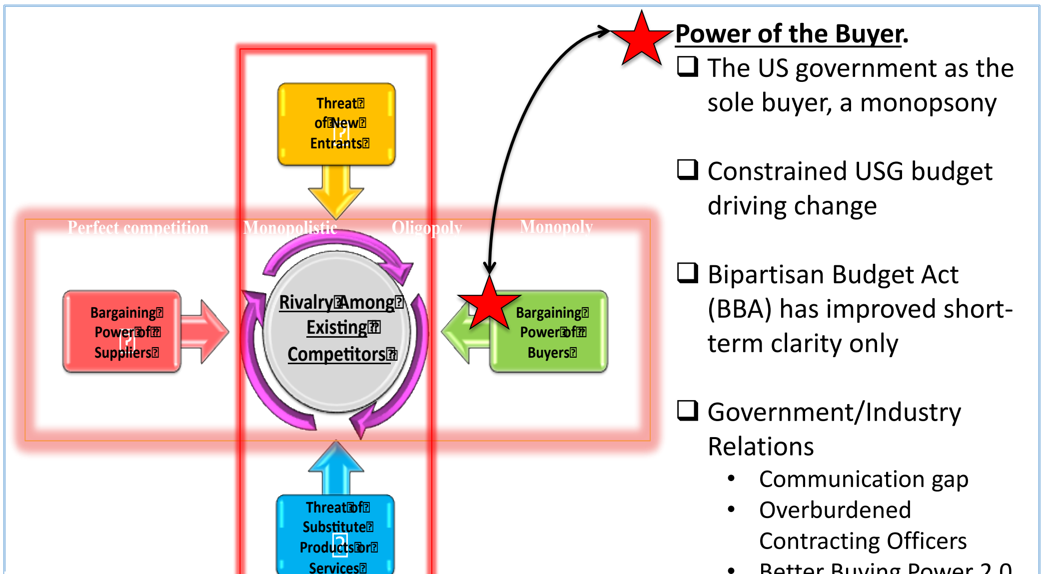


Figure 8

Another force negatively acting on the Supply/Buyer relationship is the emphasis on Better Buying Power (BBP) initiatives and the trend towards more cost conscious procurement methods.

INDUSTRY ADAPTATIONS

One of the few certainties of today's business environment is that it never stands still. Only one approach to this unsteady state of affairs makes sense: perpetual innovation – the constant shifting of strategies and tactics to reshape the business and take competitors by surprise.[37]
– Steven Shapiro, 24/7 Innovation

Private corporations have several options available as they adjust to a new operating environment. An analysis of the PS3 firms through the available literature and face-to-face interactions gives an indication of successful strategy for the coming years. The strategies include some iteration of Mergers & Acquisitions or drives for efficiency, such as divestitures of

"What if we don't change at all ... and something magical just happens?"

underperforming units, cost cutting and efficiencies, and diversification. This is not much different from the strategies followed by the major hardware manufacturers at the end of the Cold War. Then, at the Pentagon's urging, defense manufacturers began taking consolidation actions that lasted until Lockheed Martin tried to buy Northrop Grumman in 1997, at which point government regulators halted further consolidation within the industry due to concerns regarding competition.[38] What defense contractors learned from the nineties drawdown is the government regulators favored consolidation, but only up to a certain point. Through consolidation, the majority of the major American defense manufacturers survived and, in some cases, thrived. Today, industry representatives stated the defense services sector has room for consolidation given the large number of firms operating within the industry and the DoD's shrinking budget.[39] In fact, the top twenty defense service contractors control only forty percent of the market, indicating there are enough firms to support consolidation.[40]

Mergers & Acquisitions

Mergers and Acquisitions is a mechanism to combine two companies into one larger firm. A merger is a friendly or at least amicable process, because the two companies become one by mutual agreement.[41] An example of a large successful merger from the Cold War drawdown is Martin Marietta, whose company executives recognized the approaching defense spending cuts and starting preparing in the mid-1980s. This early preparation enabled Martin Marietta to merge with Lockheed as equals rather than Lockheed taking them over.[42] An acquisition is slightly different because one company takes the dominant position and acquires another. Like the previous example, two companies become one, however, in an acquisition the subordinate firm is "swallowed up" by the other and ceases to exist; the merger is essentially hostile.[43]

There are several advantages to merging two companies; it provides companies the opportunity to reduce costs, increase revenue, diversify risk, increase economies of scale, and acquire capability, all necessary to better position a company to navigate an austere budgetary environment.[44] The risk comes from a contracting of the defense services base, perhaps not at the top tier, where an oligopoly already exists, but in the mid-tier companies. Large companies have the market presence and resources to operate within the defense services market and small businesses benefit from the government's small-business set-aside programs.[45] According to Michael Murphy, the squeeze on mid-tier companies directly affects National Security because these companies are the source of much innovation and research.[46] The effect if this squeeze is borne out by research done by the Center for Strategic and International Studies. The study found (for the professional services contractors), "mid-tier firms market share fell from 44 percent of total contract value in 1995 to just 33 percent in 2007 and that large companies increased their share from 37 to 46 percent during the same period."[47]

While economies of scale may be best suited for competition for scare defense dollars, the defense procurement establishment must address any potential loss of innovative research or the ability to provide an agile response to changing security requirements. By ceding the competitive landscape to the large primes and a coterie of small businesses, the government may be losing a key driver of innovation.[48]

The pressure to merge amongst the small business service providers is not as intense, or lucrative as on the mid-tier firms. The government establishes certain thresholds in terms of revenue and/or work force that companies must remain below to qualify for the small-business set-aside program.[49] Consolidation among the small businesses could cause them to exceed the thresholds and lose their qualifications for set-asides, forcing them to compete in the mid-tier category. As the Center for Strategic & International Studies report, US Department of Defense Contract Spending, highlights, with the mid-tier squeeze in effect there is little or no economic incentive for small businesses to consolidate.[50]

Restructuring & Divesting of Company Units

Companies can divest themselves of less profitable or non-core businesses as a means of reducing cost. Although companies continuously review their business portfolios, it is when there is a market downturn that companies put a more concerted effort on their reviews. Loren Thompson from *Forbes.com* gives an example of this when describing how the defense industry's prime contractors rushed into the defense service market during the boom times, viewing defense services as, "the wave of the future in military demand," only to find them desperately trying to exit the services market now as the drawdown is in full swing.[51] By shedding non-core businesses, companies can lower costs, reduce drag on their earnings, and invest more capital into the core business as well as operate more nimbly to respond to changes in the marketplace.

Recent examples of divestiture include several of the larger companies in the industry. In 2002, Northrop Grumman made one of the last deals in the previous round of consolidation, acquiring TRW to claim a spot among the defense giants. Less than a decade later, in 2009, Northrop started peeling apart the giant company, first selling off its advisory services unit, Tasc, and then, in 2011, it spun off its shipbuilding business, Huntington Ingalls.[52] In 2012, Science Applications International Corp (SAIC), split itself into two companies, one a technology business focused in areas impacting national security and health, and another for the government services business.[53] Most recently, in 2012 L-3 Communications' decided to spin off Engility and Exelis announced it would restructure its government services unit into a public company in June 2014.[54]

Cost Cutting and a Search for Efficiencies

While most businesses are enticed to reduce costs as part of their normal business plans because it leads to higher profit margins, ten years of large defense budget increases did little to incentivize companies to reduce their costs. As John Dowdy of the McKinsey group points out, "When the budget just keeps going up, up, up…strong businesses do well, OK businesses do well and even poor businesses do well."[55] It is usually when revenue begins to decline that there is a renewed focus by businesses to reduce costs so they become more competitive, more efficient, and more attractive to investors (critical to financing). There are also benefits in increasing cash flow to ride out the downturn. As one Chief Financial Officer stated, "The winners will be those companies that can best trim costs, reallocate capital and invest resources."[56]

Diversify Revenue Streams

During the nineties downturn, some companies such as Magnavox and Texas Instruments elected to leave the defense sector all together. In other instances, companies such as Boeing reduced their reliance on the defense-side of their business and instead increased their business focus on the commercial-side.[57] This same lesson is applicable to today's defense service companies as they seek to add other sources of revenue.

There are various ways to diversify in order to meet market demand. Companies can explore offering their services overseas to foreign companies, militaries, and/or governments; however, this action can be risky for companies as they work to establish a foothold in these countries, and it may present a relative high barrier to entry due to the numerous tariffs, trade laws, and import/export laws. One way around the barriers is to enter new overseas markets through a joint venture, alliance, or partnership with companies already operating inside foreign markets. By utilizing these types of business arrangements, companies can gain entry into foreign markets as well as acquire competitive insights from their local business partners that will enable them to branch out on their own.[58]

The commercial sector is another target market for a diversifying defense service company. This is especially true for those services that have similar commercial applications such as information technology, private security, logistics, training, and even intelligence.[59] The industry is already witnessing companies expanding into the commercial sector. Exelis is branching out into the non-military and commercial markets for its products. L-3 Communications is working on growing its non-domestic defense businesses by focusing on improving its share of the commercial and foreign military sales markets it operates in.[60] SERCO is expanding its presence in the healthcare market.[61] These companies are just a few examples of defense service businesses expanding their revenue diversification in order to offset expected losses in DoD revenue. The chart below (Figure 9) summarizes recent and ongoing strategic activity and restructuring in the defense and government services sectors.

Figure 9

GOVERNMENT CHALLENGES/ROLES

While Industry is adjusting its business strategies to survive in a tough economic environment, the government must also review its processes and roles to build on the lessons learned of the past decade of high demand for contractor support. This portion of the paper will identify some areas where the government faces challenges in meeting operational requirements in an austere environment, along with some recommendations on how to improve government/PS3 interactions.

Challenge One: Institutionalizing Contract Services Planning

The planned withdrawal from Afghanistan and the period of austerity the U.S. is entering have created an inflection point. The current scenario of colliding trends presents a distinct danger that the opportunity to institutionalize contract services planning will fall by the wayside as contingency contract actions cease and service components focus their resources on defending legacy programs. These colliding trends are decreasing defense spending, increasing use of contract solutions to provide necessary capabilities, and increasing complexity of tasks performed by contractors. The Joint Staff's J4/OCSS office, in concert with the Office of Program Support in OSD AT&L, initiated several mechanisms designed to instill OCS planning processes in the joint force. The recommendations made across the DOTMLPF (Doctrine, Organization, Training, Materiel, Leadership and Education, Personnel and Facilities) spectrum in the OCS Joint Concept lay an important foundation for OCS planning and must continue to receive SECDEF level support as well as funding.

In most cases, to institutionalize an idea in an organization, the leadership must actively sponsor it for the members to accept the change.[62] The service components are no different. They have a title 10 responsibility to organize, train, and equip to provide capabilities to the combatant commanders. Attachment 1 shows critical components tied into the planning process from the various J-series directorates in a CCMD; each of the service component directorates have contract solutions that are part of those capabilities they will provide in contingency scenarios. Thus, they are a crucial part of the planning process. To drive their integration into the planning structure described above, each service component must have full buy-in at the Service Secretary level and a sponsor designated within the service with responsibility for oversight and execution of the contract services solutions that are part of the service component's capability portfolio. In the OCS Joint Concept, this idea is embodied in the function of a service component executive agent (EA).

However, the sponsor (or EA) concept should be specified as the service component Program Executive Officer (PEO) for Services. This concept was specified in law in in the National Defense Authorization Act of 2002.[63] However, it has never truly come to pass in any meaningful way. As the Gansler report showed in 2009, while the Navy and Air Force had created some semblance of a Services PEO, the Army was still lagging. This is still the case today; no service is considered fully effective in integrating contract service solutions across their service component.[64] By fulfilling this congressionally mandated requirement, the service components will have the sponsorship needed to shepherd contract service solution planning and execution. Fully establishing service component PEOs will require direction from the Secretary of Defense to the respective Service Secretaries to prioritize fully implementing the PEO legislation. If this is insufficient, institutionalizing contract services sponsorship may require additional pressure from Congress.

To truly institutionalize planning for contract solutions the recommendations in the areas of strategic guidance, organization, and training must be expanded and be more specific to achieve the necessary impact and development of an OCS planning annex to the Joint Strategic Capabilities Plan initiated. Organizationally, responsibility for the effective use of contract solutions goes to the CCMD lead planner, along with necessary training. Training via the Joint OCS Planning and Execution course is also necessary for the planning elements within the service components because they are the force providers. To truly effect change, greater service component sponsorship is essential; achieved by establishment of a truly effective service component PEOs.

Long term defense planning rests on the ability to align resources and assess areas of acceptable risk. The final piece to effectively incorporating OCS planning and assessing risk is available through capitalizing on data created through a new Joint Staff sponsored exercise. OCSJX-14 demonstrates a vehicle that can be used to aggregate data into a usable form to ensure the services industry understands DoD's future requirements. It also allows strategic planners to forecast effectively where risk is acceptable in both military and non-military capabilities.

Challenge Two: Address Weaknesses in Contracting Officer's Representative (COR) Performance

Contract management and oversight has become more challenging due to an increase in the number of contracts, training burden challenges, a shortage of oversight personnel, a high personnel turnover rate, and an increase in the complexity of the work contracted.[65] In 2011, the Commission on Wartime Contracting reported, "poor planning and oversight by the government and poor performance by contractors had resulted in wasted resources, missions not being achieved, and the loss of lives."[66] The Special Inspector General for Afghanistan Reconstruction's (SIGAR) most recent quarterly report to Congress states:

> These reports identified a number of problems, including poor planning, management deficiencies, and oversight failures as well as project delays, shoddy construction, and threats to health and safety. SIGAR investigations led to more than $63 million being frozen in bank accounts, two arrests, three sentencing's, and more than $95,000 in fines and restitutions.[67]

In order for CORs to properly manage and oversee contracts, DoD must prepare them with in-depth and required training, ensure the appropriate technical expertise, and ensure a sufficient number of CORs are in-place to be effective and efficient. DoD guidance requires CORs be trained and assigned prior to the award of a contract; but much DoD training is only intended to familiarize the COR on the duties and responsibilities of contract management and oversight.[68] However, gaps in training still exist, especially for unique, remote, and unstable environments like Afghanistan (high vs. low risk OCS).[69]

One noted deficiency is the failure to hold Contractors accountable in meeting contract requirements. U.S. policy trends directed towards contractor accountability can be broken down into two key aspects. The first relates to felony violations of U.S. law. The Military Extraterritorial Jurisdiction Act (MEJA) is a law intended to place military contractors under U.S. law.[70] This law approaches contractor accountability from the perspective of holding individuals accountable for their actions. The second key aspect of contractor accountability relates to administrative oversight of contracts, primarily the responsibility of the COR. As the Military Extraterritorial Jurisdiction Act (MEJA) has only been used three times to successfully prosecute someone, this paper will focus on the second aspect related to administrative oversight and the COR.

The Government Accountability Office (GAO) argues that failure to integrate contractor support into Professional Military Education can leave the military unprepared to manage contractors. They concluded that, “[T]he lack of contract training for commanders, senior personnel, and some contracting officers’ representatives can adversely affect the effectiveness of the use of contractors in deployed locations. Without training, many commanders, senior military personnel, and contracting officers’ representatives are not aware of their roles and responsibilities in dealing with contractors.”[71]

DoD policy requires that the requiring activity/COR management participate in nominating CORs and assess their performance of COR responsibilities.[72] COR management affirms that the COR will be afforded necessary resources (time, equipment, opportunity) to perform designated COR responsibilities.[73] However, many officers and government officials who worked in Iraq and Afghanistan stated there were simply not enough resources or personnel in theater to conduct adequate contractor oversight, leading to poor contract performance.[74] This overload of responsibilities resulted in a recommendation that COR duties to be established as a permanent, dedicated duty rather than a collateral duty.

Another deficiency was the inability of CORs to recognize and fight fraud, waste and abuse by contractors. Again, the common causes, as described in the GAO report revolved around COR training and excessive workload. Specifically, CORs lack of understanding the full scope of their responsibilities resulted in a deficiency of oversight of contractors meeting the proper requirements. Training programs also lacked specific protocol on the preparation of statements of work or documents required for acquisition review boards.[75] Poorly written statements of work increased the procurement process time, delays and disruptions in critical supplies and services, and the workload burden on DoD contracting personnel needed for the mission.[76] Lastly, “DoD has not expanded the professional military education curriculum by increasing the number of training offerings on OCS with a specific emphasis on contingency operations.”[77]

Although contingency contracting may be downsizing with the war terminations in Iraq and Afghanistan, the reconstruction efforts and potential for future contingencies will keep contracting requirements at the forefront of DoD’s planning and budgeting requirements. In addition, DoD will continue to be vulnerable to contracting fraud, waste, and abuse unless it makes planning a core competency, instills adequate management, and oversight by enforcing proper training programs, technical expertise, and provides a sufficient numbers of CORs. Due to the size of fraud, waste, and abuse cases over the last several years, Congress has enacted legislation in order to minimize the vulnerabilities. The OSD and Joint Staff have responded by issuing several new and revised policies, undertaken actions, and are currently revising additional policies regarding OCS; however, DoD has not yet fully institutionalized these policies at the combatant commands or components, where much of the operational planning occurs for contingencies. To successful reduce or mitigate fraud, waste, and abuse, a cultural change must happen by making OCS planning, management, and oversight a core competency among all services in DoD.

Challenge Three: Contracting for Services – Balancing the Best Value Trade Offs

> *"It appears the acquisition gray-beards have departed government service without true knowledge transfer on complex or best value with trade-off acquisitions." – Anonymous Industry Feedback*

In this post conflict era, the DoD finds itself increasingly challenged in an environment where shrinking budgets and resources that are more constrained have become an unavoidable reality. Throughout our visits with the PS3 community, there was a broad consensus that current contracting practices within the DoD were a source of contention rather than collaboration, with a key factor being a definitive trend towards low cost rather than best value contracts.

A selection of anonymous comments from the companies visited during the course of this seminar is transcribed in the Sidebar. A further discussion of the salient issues regarding LPTA usage is provided in Attachment 2 of this paper. Today the PS3 community finds itself challenged, and increasingly at odds with, the DoD contracting community's increasing reliance upon and expanding use of the LPTA source selection technique. This portion of the paper will provide a brief explanation of the intended and appropriate use of LPTA and Best Value as a source selection criterion followed by an analysis of why LPTA is becoming more prevalent, even for complex services and what government can do to improve the source selection process to achieve better results.

In October 2013, Market Connections, Inc. and Centurion Research Solutions released a collaborative study reporting on the impacts of LPTA after surveying 375 government contractors and 360 civilian and defense decision-makers in government. The results were quite revealing, highlighting that a majority surveyed reported the LPTA landscape had, in their collective opinions, curtailed innovative solutions, lowered performance standards resulting in less-desirable government solutions, and sacrificed long-term value for short-term cost savings.[78] Although this study conclusive, in large part due to its extensive size and scope,

PS3 INDUSTRY FEEDBACK ON LPTA CONTRACTS*

"We are cautious of all LPTA acquisitions because of the number of firms willing to undercut margins for low-bid vice best value or innovative approaches."

"The Government, specifically DOD, is terrible at writing requirements. Half the time, they do not know what they want."

"LPTA has become an absolute race to the bottom. As a company on the forward leaning edge of technology services, we are extremely selective and not very supportive of LPTA."

"The government seems blind to the consequential effects LPTA has on personnel retention in a business where human capital is the core competency. We either decrease the pay of professionals based on their merit of experience, or green the position with less experience, but can meet the government's minimum stated requirements."

"LPTA seems to support the inexperienced acquisition workforce. It promotes less communications between the government and contractors and requires less creative thinking. Pair this with a mindset that there is less risk of protest and supportive to shorter timelines."

"LPTA has become a predominant mentality in government, and in response from industry, LPTA has become a shoot-for-the-floor strategy."

All comments are anonymous to preserve confidentiality of the source.

anecdotal evidence collected from the PS3 Industry interactions sharpens the aforementioned points even further. One recurrent theme is the lack of knowledge within the government contracting community on proper contracting practices. Many acquisition professionals consistently and incorrectly refer to best value when they mean the best value continuum using tradeoffs to accomplish the source selection process.[79] The best value continuum ranges from LPTA, where cost factors are most important, to tradeoff, where non-cost factors are most important (such as quality and schedule). The image below (Figure 10) illustrates the tradeoff relationship.

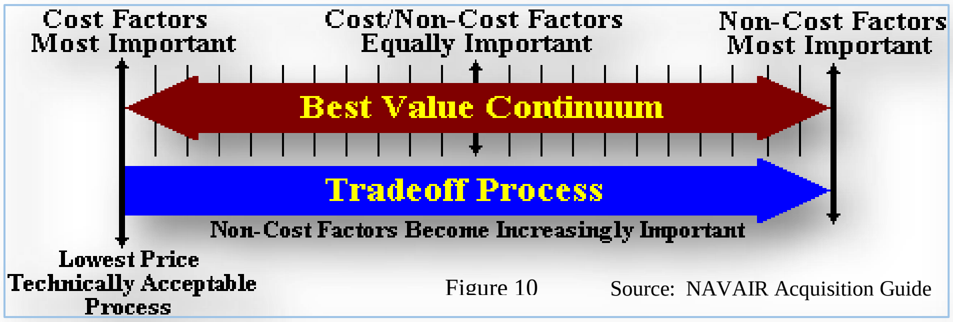


Figure 10 Source: NAVAIR Acquisition Guide

Discussions with our industry and government partners determined that the austere budget environment, along with a drive to find money saving strategies, is propelling the trend towards LPTA, sometimes with poor results. The easier format of LPTA also helps a diminished DoD acquisition workforce reduce cost overruns without extensive new training.[80] In response to a number of poorly executed acquisitions, the Government Accountability Office (GAO) issued a report in 2010 that pointed out the need for DoD to enhance training on several acquisition practices, to include source selection decision processes. This sparked the first round of Office of the Secretary of Defense (OSD), Acquisition, Technology and Logistics (AT&L) Better Buying Power (BBP) initiates to improve acquisition efficiencies.[81]

As sequestration and other austerity measures gained full impact in 2013, a revised BBP 2.0 emphasized users to “think” and only apply the guidelines when applicable. In the area of source selections, BBP 2.0 recommended to better define the value in best value competitions and to limit the use of LPTA.[82] In the meantime, several key industry leaders continued to criticize Defense agencies for using LPTA to procure “sophisticated, vaguely defined, mission essential supplies and services.”[83] In response, senior Defense officials stated that using LPTA was still necessary and appropriate when a proposal had clearly defined technical parameters but inappropriate when an agency intended to seek innovative solutions or would share the risk of developing the required technology.

To help acquisition professional successfully determine the best approach to acquire goods and services, the PS3 seminar determined that the government should continue to expand on BBP 2.0 by updating FAR Part 15 to clarify the definitions of best value and LPTA. We also recommend augmenting DFARS 215, which contains very little source selection material. Information on how to determine “technically acceptable” as well as how to incorporate combined approached, past performance, competitive ranges, and proposal revisions to provide more usable information to the Acquisition professionals. Finally, more training and updates to existing guidebooks with examples and templates on using the best value continuum will assist contracting professionals determine the best type of approach to use, depending on the procurement scenario.

Challenge Four: Improve Visibility of Support Services Spending in the Federal Budget

Given the enduring nature of reduced spending within DoD, the department must develop greater insight and transparency of its spending processes. The most significant problem with the FYDP in its current form is its inability to capture service expenses accurately and completely. Without improved visibility of service expenses, DoD and Congressional leaders will remain hamstrung in making tough decisions and develop policy relating to base spending. In 2013, DoD spent approximately $170 billion on contracted services, with the preponderance of expenses falling into the Operations and Maintenance and OCO accounts. The list of services provided is broad: ranging from health services, IT services, logistics, installations support, and base operations support. While some of these expenditures are visible in the lines of the FYDP tabulations, most remain deeply buried under larger DoD appropriations categories. The lack of visibility is wide-ranging from "what" the services are, to "why" the services are required. In many cases, it is also difficult to determine the provenance of the services provided. There are also significant inconsistencies with respect to the allocation of funds within specific programs.[84]

The resulting lack of transparency obscures potential opportunities to gain efficiencies across DoD. In a time of tightening budgets, senior leaders need to possess better visibility regarding the nature of these expenditures allowing them to provide overarching policy, oversight and assistance in understanding strategic tradeoffs. At the same time, Congress needs the best available data about DoD's resource tradeoffs between competing priorities. To remedy the lack of visibility and transparency, the we recommend that DoD add "Services" as an additional appropriations category. Adding this basket would greatly enhance visibility, accountability and rigor with respect to contracted services. In addition to better supporting DoD and Congressional oversight and decision making, it would also improve transparency across the force and with the industrial base working in the services arena.

ASSESSMENT FOR THE FUTURE OF THE COMPANIES WITHIN PS3

An organization's ability to learn, and translate that learning into action rapidly, is the ultimate competitive advantage – Jack Welch

It is the assessment of the PS3 Industry Seminar that defense service providers will continue to search for comparative advantage in order to survive the coming lean years. The prognosis for the services industry varies greatly by subsector, with some areas such as cybersecurity, information technology, and healthcare services expected to hold steady or grow. Service vendors who fail to diversity will experience a tremendous increase in competition in other defense markets such as security and administrative services as spending declines. As the U.S. government moves to streamline service contracts, the private sector should anticipate an increase in larger award, indefinite delivery, indefinite quantity type contracts.[85] This bodes well for the big six and larger tier companies who can compete for larger contracts, as well as small businesses who gain advantage through small business set-asides. However, this creates a situation of "squeezing out" of mid-tier vendors for defense service contracts and the potential to lose necessary innovation within the service providers. To survive without becoming an acquisition target the trend for mid-tier vendors has been to diversify their customer base to include other governmental agencies, as well as diversification into commercial and global markets. The broadening portfolios of large and medium tier companies afford them opportunity maintain a competitive advantage in these diverse markets. Many of the large and mid-tier companies have adopted this diversification strategy in order to maintain profitability until the U.S. Defense markets provide a clearer economic future.

As competition increases, the quality and productivity of services provided will also increase. The net result of U.S. defense austerity may actually be a globally diversified private sector service industry that is financially independent of the vagaries of the defense budget going forward. The rebalance of the PS3 industry will result in an industry with a different vendor composition, but retaining its capability of meeting future contingency requirements. The onus now is on the government to be more effective in identifying future requirements.

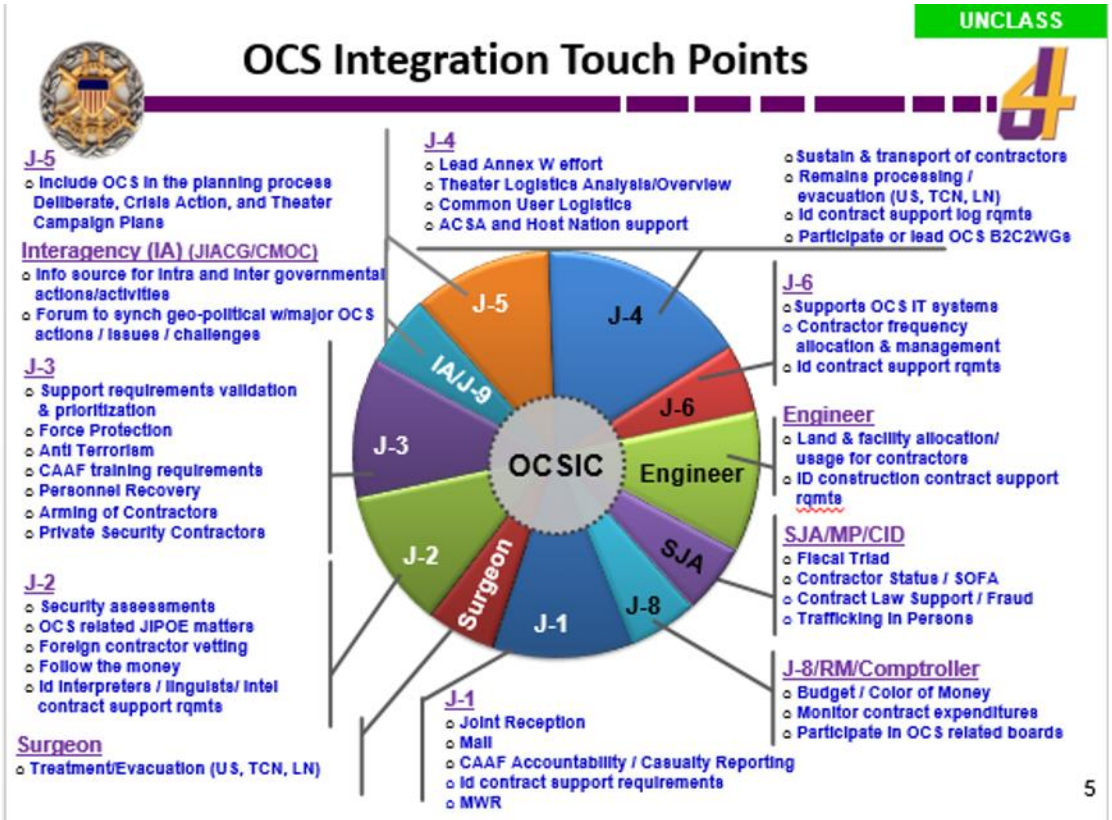
CONCLUSION

Our seminar analyzed the changing economic and national security environment that is triggering widespread changes within the DoD agencies that contract for services and the companies that provide them. Our findings show that structural changes such as the drawdown of wartime operations, a declining defense budget, economic uncertainty, and a shuffling of defense priorities is having a profound effect on the companies who operate within the PS3 environment. However, the resiliency and ability to adapt by the PS3 firms mean, that while a certain amount of restructuring and downsizing may be inevitable, we expect the capability of these firms to provide needed services to the DoD will remain viable, available, and financially secure.

This paper described how the pace and scope of operations in Iraq and Afghanistan stretched the COR community to the breaking point even as needed supplies and services flowed to the warfighter. Amongst the lessons learned were the need to institutionalize contingency planning and contracting for future conflicts, the wisdom of improving training resources for our COR's in the field while ensuring COR functions remain a core rather than a collateral duty. We also recommend that DoD improve materials on the best practices to contract for services, including the determination of the most appropriate for of contracted service, whether it be Lowest Price Technically Acceptable or some other solution along the Best Value continuum.

Finally, we acknowledge that the military services will rely on contractor support for a variety of vital functions, even within a peacetime operating environment. For that reason, we recommend that government work hand-in-hand with the PS3 community to communicate requirements more effectively so both parties enter into mutually satisfying contractual agreements.

ATTACHMENT 1: PLANNING RESPONSIBILITIES ACROSS CCMD DIRECTORATES



Source: OCSJX-14 Executive Brief. Used with permission of Col Mike Hoskin, Division Chief, J4/OCSS, Joint Staff.

ATTACHMENT 2 – A DISCUSSION ON PITFALLS OF LPTA CONTRACTS

LPTA fails to recognize, reward or incentivize innovation.

Price over performance can too often deprive the Government of innovative solutions and advanced capabilities. Repetitive Government LPTA acquisitions fail to incentivize those contractors who solely support the Defense Industry to continue expending Internal Research and Development (IRAD) dollars, as opportunities to recoup those efforts are severely diminished. Companies that financially prioritize and invest in innovative products and services generally will not cut the margins on LPTA acquisitions, as this pits future revenues against minimal technically acceptable requirements. "Eliminating comparisons of capability and performance has the unintended consequence of discouraging competing bids from companies that offer a more capable product at a price they cannot afford to lower."[86]

LPTA erodes the complex and professional services talent pool.

The Defense Services Industrial Base is dependent on the skills, abilities and professional expertise of its human capital. Retaining this coveted talent pool is a strategic goal of every company claiming complex and professional services as primary core competencies. To the Government's disadvantage, when LPTA is applied for such services, the defining factor in this competitive environment can only be based upon the pricing strategies for that talent. As a result of LPTA, companies simply cannot maintain their very best and brightest professionals on Government contracts. The common technique is to 'green' the position with a less experienced individual, albeit one who can still meet the minimum technically acceptable requirement.

LPTA is being misused for acquisitions against complex requirements.

The Government's misuse of the LPTA source selection criteria for complex and professional services is counter-intuitive when attempting to clearly define complex requirements. As opposed to seeking Best Value through Trade-Offs, LPTA demands that the Government's Program Managers and Requiring Activities must "spell out all requirements – down to the smallest details, some of which may have gone unspecified in the past, in order to ensure that the needed requirement, as envisioned by the Government, is fully met."[87] Considering the Government has traditionally had its difficulties writing requirements, and it is a widely-held perception that LPTA significantly reduces open communications between Government and Industry, 'spelling out the smallest details' may simply be untenable.

LPTA is inhibiting Government's ability to apply critical thinking.

In an environment where both budget austerity continues to loom and acquisition suspense and requirement timelines are continuously being shortened, LPTA source selections have become the expanding default and perceived complacent position of the Government. Consequently, this is adversely affecting and harming the Government's abilities now, and will conceivably continue to do so in the future if left unchecked. Knowledge of Best Value with Trade-Offs acquisitions, and the capacity to think critically on the part of Program Managers, Requiring Activities, and, most importantly, contracting professionals, appears to be severely lacking. It has been repetitively conveyed that the inappropriate use of LPTA for acquiring complex and professional services encourages the Government's inexperienced acquisition workforce to eschew further technical development.

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