

**Defense Business Environment**  
***Mid-Sized Company Perspective***

***Bradford L. Smith, Jr., President, Strategic Analysis, Inc.***

**Introductory Comments.** My name is Bradford Smith. I want to thank you for the opportunity to testify before the HASC Defense Business Panel. I am the owner of Strategic Analysis, Inc., a small to mid-sized business that provides professional services to Federal Agencies. Strategic Analysis (SA) is a service-disabled, veteran-owned business founded in 1986. We have ~250 employees supporting a wide range of U.S. Government clients with offices in Arlington, VA, Washington, D.C., Colorado Springs, CO and Dayton, OH. We provide professional services to US Government Agencies and components to include:

- Systems Engineering and Technical Assessment / Advisory and Assistance Services
- Advanced Concepts and Intelligence Support Services
- Information Technology Services
- Conference Planning Services

We work for the Departments of Defense, Energy and Homeland Security. For most procurements, we are a large business. For some we are a small business. I am making suggestions based on 38 years of experience in competing for business in government professional services.

As I understand the format of this hearing, each of us is to provide a short set of remarks, followed by questions from the Panel. My remarks address the use of incentives and mandates to shape the defense business environment.

One specific concern of mine comes from the current trend toward ultra-large indefinite delivery indefinite quantity contract set-asides for very small businesses. The tendency to “bundle” procurements is also prevalent in full and open competitions. Today’s highly constrained budget environment is likely to cause a greater emphasis on contract bundling. I am concerned that the very small companies that win such ultra-large set-asides must focus their resources on strong proposal and program management capabilities rather than on their unique skill sets and people. This trend is discouraging innovation in a sector of the industrial base where much of our innovation starts.

Secondly, I am concerned that mid-sized businesses are being excluded from most set aside competitions. Mid-sized companies are too big for such competitions and must compete in full and open competitions. I find it hard to believe that a company with 250 employees is too big to compete for \$1B, 5-year service contracts. Growth to mid-sized for us was not as a result of a specific small business set-aside program, but instead was the result of our reputation for quality and our desire to provide more opportunities for employees.

Many owners in my position have chosen to sell their mid-sized companies as an exit strategy. We have not. I truly believe that the government is losing a significant part of its industrial base as mid-sized companies merge with larger businesses. The CSIS study that I reference in this paper shows quantitatively the squeeze now facing mid-sized businesses.

Mid-sized companies provide a significant resource for the Department of Defense. The differentiation of small, mid-sized and large businesses highlights the continuum of companies. Mid-sized companies are as innovative as small businesses, they are agile in the marketplace AND they are a significant creator of jobs. The conventional wisdom is that job creation starts with small businesses. Mid-sized companies can actually generate more jobs.

I also want to highlight one regulation that makes the problem worse for small businesses, the “51%” rule. A small business that wins a prime contract set-aside for small businesses must execute at least 51% of the effort. Even while teamed with other small businesses, the work provided by such teammates is not counted as part of the 51%. To get the work of all small businesses to be counted, they must form Joint Ventures of similarly-sized companies, a risky endeavor. In fact, the Air Force was forced to change its approach, which was more flexible. Where it made sense, the Air Force was allowing the 51% work requirement to be met by all of the small businesses on the proposed team. The 51% requirement has caused winning prime contractors to outgrow the small business size standard over the period of their 5- or 10-year contract, bringing them to a crossroad at the end of the contract when they cannot compete for the follow-on contract.

Although consideration of the definition of inherently governmental is not specifically mentioned in the scope of your deliberations, I recommend that you address it. OMB recently issued a policy letter attempting to clarify the definition of inherently governmental and establishing a policy. I suggest that the government stay with current FAR definitions and regulations. The new policy letter introduces new concepts of services closely associated with inherently governmental functions or services in critical functions, which will likely lead to unnecessary in-sourcing and, in some cases, will not provide the “best value” solution that would result from competition.

My submission provides more on each of these including the supporting rationale. Here are a few suggestions.

The Mid-Sized Business “Squeeze.” I suggest the Panel explore ways of supporting mid-sized businesses through, for example, creating a new set-aside program; modifying NAICS codes; or modifying the small business size standards to encompass mid-size businesses. Service areas in direct support of government agencies and components are an example of where such a set-aside is in the public’s interest; for example, services where companies are required to agree to Organizational Conflict of Interest restrictions such as advisory and assistance contracts and systems engineering and technical assistance contracts (A&AS and SETA). They require broad technical expertise; reach back capacity; and strong program management processes, capabilities that smaller businesses do not typically have. Further, mid-sized companies are not so large that that have inherent organizational conflicts of interest.

Ultra-Large, Multi-Award, IDIQ, Small Business Set-Aside Contracts (and the 51% Rule). Ultra-large, multi-award, indefinite delivery indefinite quantity (IDIQ) contracts for services are a poor choice for small business set asides. My suggestion for the Panel is to recommend that set asides be designed to exploit the unique skills and character of small businesses rather than awarding contracts to small businesses that have the strongest program management capabilities. Also, consideration should be given to changing the “51%” rule allowing small businesses to team with other small businesses in a prime-subcontractor approach and let their combined effort count as the 51%.

Lack of clarity regarding inherently governmental, closely associated and critical functions. The government has a fiduciary responsibility to maintain functions that are inherently governmental. Beyond that, the public interest is in gaining the “best value” for tax dollars expended. Private companies welcome competitions where they can show that they are truly “best value.”

Thank you for your time.

## The Mid-Sized Business “Squeeze”

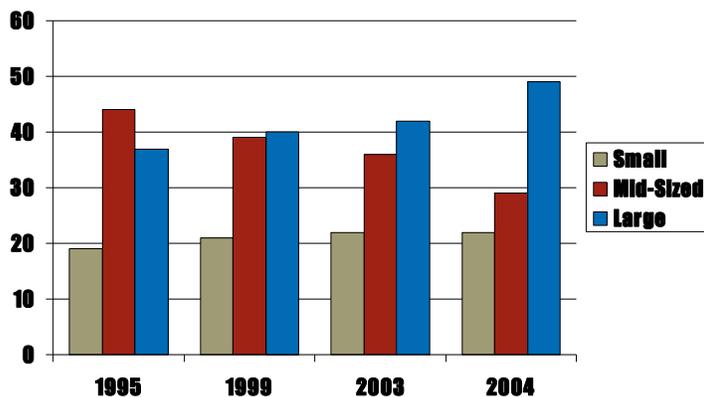
### 2009 CSIS Study of the USG Professional Services Industrial Base

- Industrial base for professional services changed significantly between 2001 and 2007
  - The total number of companies increased from 45,000 to 118,000.
  - 101 companies having more than \$100M in services revenue
  - 20 largest services providers all have annual revenues exceeding \$1B
- 2009 CSIS study shows the significant decline in contracted effort by mid-sized businesses, including larger small businesses (500 to 1500 employees)
  - From above by consolidation of both industry and requirements
  - From below from a small business set aside program that emphasizes smaller small businesses

\*[1] Structure and Dynamics of the US Federal Professional Services Industrial Base 1995-2007; David Berteau, Guy Ben-Ari and Gregory Sanders, Center for Strategic & International Studies, February 2009.

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### Market Share of Small, Mid-Sized and Large Firms



## Mid-Sized Companies Evolution

- Many successful small businesses grow into mid-sized companies
  - Retain the culture of small and the specialization that has made them a success
  - Evolve enough corporate infrastructure to support more people, more contracts, and more oversight
- Staying in business niches becoming harder
  - Larger and larger procurements for services
  - The competitive landscape favoring breadth
  - The need to implement the stylized processes necessary to compete for prime contracts has become more important than specialties
  - A heavier reliance on subcontracts, which puts business success in the hands of large businesses
- Natural evolution is to be acquired by larger businesses

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## Set-Asides for Services

- Primarily for smaller small businesses
  - Often the size standard is \$27M and requires the bidder to perform 51% of the work as well as be able to work throughout the United States and overseas
  - Bundling is creating ultra-large IDIQ procurements for technical services (often with ceilings of >\$100M per year)
  - It is essentially impossible for a very small company to successfully accomplish such a breadth of work without a large business partner
- Incumbent large primes are determining the winners by selection of their partner
- Mid-sized companies and other smalls getting factored out as the work share primarily sits with the small prime (who has to perform >50% of the work) and their chosen large subcontractor

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## **Case Study: Air Force Approach for Mid-Sized Businesses**

- Significant experience in the acquisition of SETA and other acquisition-related support services
  - Capitalizes on the strengths of all three company sizes, including mid-sized companies
- Air Force created larger small business categories for SETA work
  - Wright-Patterson Air Force Base was able to gain SBA approval for additional size standards for NAICS 541712, Research and Development in the Physical, Engineering and Life Sciences
  - The normal size standard for 541712 is 500 employees, however for Space Vehicles, Space Propulsion and Equipment, Aircraft Parts and associated categories the standard is 1000 employees and for Aircraft the size standard is 1,500
- Air Force is now pursuing a heavily small business SETA acquisition approach under these NAICS codes
  - USAF gains access to companies with more technical reach
  - Companies providing support are not so large as to have built-in OCI

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## **Two Birds, One Stone**

- Create a new set-aside program for Mid-sized companies
  - Service areas inside OCI envelope (SETA and A&AS)
  - Implement a company certification process like that of NRO
  - Set contract size standard to prevent automatic disqualification of primes in follow-on
  - Sets aside work for mid-sized companies similar to small business set asides
  - Requires achievement of small business goals
- Why?
  - Supports natural evolution of stand-alone small businesses
  - Provides better opportunity for contract stability
  - Greatly reduces OCI risk
  - Stronger support for the small business community as a whole
  - Allows niche companies to keep their focus

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### **What is an Indefinite Delivery Indefinite Quantity Contract?**

- Defined in the FAR
  - Indefinite quantity during a fixed period
  - Government places orders for individual requirements
  - Preference to multi-award
  - No protests allowed for initial task-order contract or delivery-order contract, except if out of contract scope/period/value and/or over \$10M in task order value
  - Normally 5 year limit

### **Preference for Small Businesses**

- Professional services carry lower infrastructure requirements
  - Work on Government site
  - No capital investment
  - Typically no labs/building footprint needed by contractor
- Services carry a lower cost
  - Smaller IR&D programs
  - Highly billable staff
  - Lower fee (sometimes capped at 8% depending on contract type)
- OCI not as prevalent
- Meet small business goals

## Large Means Really Large

- Why Move to Consolidation?
  - Decrease contract Government costs
  - Increased awareness of all agency activities as they come through one shop
  - Reduced duplication of efforts
- Examples of small business ultra-large contract set asides (over 5 years):
  - GSA Alliant - \$15B
  - Joint N2A2S - \$200M
  - AF NETCENTS II SB - \$5.39B, \$960M...(Multiple Categories)
  - GSA VETS - \$5B
  - Army SMDIS II - \$245M
  - Army SMIDIS III - \$450M
  - AF CAPS - \$300M
  - Army COSMIC - \$932M
  - Note for Reference: Seaport-e (Full and Open) - \$19.5B

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## Trending of Consolidated, Multi-Award IDIQ Contracts for Services

- Over the past decade, multi-award IDIQ contracts have become the preferred contracting approach for services
- This approach combined with consolidation initiatives have resulted in ultra-large IDIQ procurement for services (often with ceilings of >\$100M per year)
- Services contracts have been quite appealing as ones to target for set-asides and have continued even with these new high ceilings

*Result: Ultra-large, multi-award IDIQ procurements for services set-aside for small businesses*

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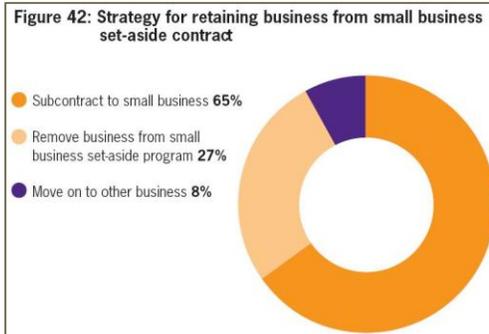
## Inadvertent Consequences

- Loss of technical innovation
  - Under an IDIQ, all work is competed, even work that may be a result of a single vendor's investment (i.e., IR&D)
  - Vendors with innovation will start to look for vehicles that allow them to deliver the client their ideas without the risk of losing the work to a competitor (usurp the contract vehicle) – or look for other clients altogether (no benefit for the intended target client)
  - In today's "no sole source" services procurement world, services vendors are losing incentive for innovation
  - Lowest price, technically acceptable approaches lead to requirements for lower overhead - companies forego IR&D
  - No credit for technical innovation
  - Firm fixed price leads to no room for additional research beyond initial scope

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## Inadvertent Consequences - cont.

- Small business outgrows size standard
- Graduated small businesses are likely not eligible to prime follow-on contracts
- Become mid-sized companies
- Few other small businesses with developed client mission expertise
- Disconnect with the client
- Work force gets constantly rebadged and feel like pawns
  - Many move on to other more stable contracts



15th Annual Government Contractor Industry Survey, Grant Thornton Industry Survey 2009

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## **Inadvertent Consequences – cont.**

- Little benefit to the larger small business community; only the winning small business prime who has to perform 51% of the work
  - It is essentially impossible for a very small company to successfully accomplish such a breadth of work without a large business partner.
  - Mid-size companies and other smalls getting factored out as the work share primarily sits with the Small Prime (who has to perform >50% of the work) and their chosen Large Sub
- Small business primes become focused on management versus mission
  - Must develop processes to compete for prime contracts
  - Must continually respond to Task Orders that come out under IDIQ and manage the team
  - Reliance on large subcontractor puts business success in the hands of large businesses

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## **Proper Implementation of Ultra-Large IDIQ Contracts**

- Large IDIQ contracts for services are a poor choice for small business set asides
  - Small businesses outgrow size standard for follow-on contract
  - Weakens the link with the customer
  - Tend to get very large and cover service aspects not originally intended
- Loss of technical innovation needs to be more fully explored
- All task order types (Cost, T&M and Firm Fixed Price) work in certain applications –as well as evaluation type (LPTA, FTT,PPT)
  - Give the CO discretion to match requirement to type and monitor for good decisions
  - Often policy or common practice dictates a choice rather than common sense
  - For example, the trend toward firm fixed price contracts and task orders is often not wise if the specific details of the requirement are uncertain
    - DSB task force support is a good example (chairmen are different, number and length of meetings is different, role in report writing varies, etc.)
- Modify “51%” rule to include small subcontractors

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## Inherently Governmental, Closely Associated and Critical Functions

### **FAIR Act and Inherently Governmental**

- OMB states that an inherently governmental activity is an activity that is so intimately related to the public interest as to mandate performance by government personnel.
- These activities require the exercise of substantial discretion in applying government authority and/or in making decisions for the government.
  - However, the use of discretion shall be deemed inherently governmental if it commits the government to a course of action when two or more alternative courses of action exist and decision making is not already limited or guided by existing policies, procedures, directions, orders, and other guidance.
- Inherently governmental activities normally fall into two categories:
  - The exercise of sovereign government authority or
  - The establishment of procedures and processes related to the oversight of monetary transactions or entitlements.

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### **Final Administration Policy Letter**

- Ensure that contractors do not perform inherently governmental functions
- Especially where contracts have been awarded for the performance of
  - Critical functions
  - Functions closely associated with the performance of inherently governmental functions
  - Where, due to the nature of the contract services provided, there is a potential for confusion as to whether an activity is being performed by government employees or contractors
- Preference for US government employees in the above cases
- Employ an adequate number of government personnel to ensure contract administration protects public interest

*Policy letter leads to implementation that provides a preference to in-source functions rather than letting the mission drive the decision.*

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## Examples of Functions Closely Associated with the Performance of Inherently Governmental Functions

- Services that involve or relate to
  - Budget preparation, including workforce modeling, fact finding, efficiency studies, and should-cost analyses.
  - Reorganization and planning activities.
  - Analyses, feasibility studies, and strategy options to be used by agency personnel in developing policy.
- Services in support of acquisition planning.
- Assistance in contract management or the development of statements of work.
- Work in any situation that permits or might permit access to confidential business information and/or any other sensitive information (other than situations covered by the National Industrial Security Program described in FAR 4.402(b)).
- Participation as technical advisors to a source selection board or as nonvoting members of a source evaluation board.
- Construction of buildings or structures intended to be secure from electronic eavesdropping or other penetration by foreign governments.

*All functions listed above are commonly and successfully performed by contractors.*

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## Recommendation on Inherently Governmental Definition

- Inherently governmental functions are those that require authority and substantial discretion
  - Simple in concept
  - Examples listed in the new policy letter are the same as those in the current FAR
- What is new in the policy is the artificial definition that should have been removed:
  - Closely associated functions
  - Critical functions
- Administration is creating new distinctions to justify in-sourcing
  - Functions closely associated with inherently governmental functions should be evaluated by agencies on a “best value” basis, not arbitrarily in-sourced.
  - If it is not inherently governmental, it should not be treated as such.

### Remove discussion of closely associated functions and critical function from the OMB policy letter

- The FAR definition is sufficient.
- Treat the closely associated and critical functions using “best value” methodology.

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**FISCAL YEAR 2009**

<b>Federal grant(s) / contracts</b>	<b>federal agency</b>	<b>dollar value</b>	<b>subject(s) of contract or grant</b>

**Federal Contract Information:** If you or the entity you represent before the Committee on Armed Services has contracts (including subcontracts) with the federal government, please provide the following information:

Number of contracts (including subcontracts) with the federal government:

Current fiscal year (2011): \_\_\_\_\_;  
Fiscal year 2010: \_\_\_\_\_;  
Fiscal year 2009: \_\_\_\_\_.

Federal agencies with which federal contracts are held:

Current fiscal year (2011): \_\_\_\_\_;  
Fiscal year 2010: \_\_\_\_\_;  
Fiscal year 2009: \_\_\_\_\_.

List of subjects of federal contract(s) (for example, ship construction, aircraft parts manufacturing, software design, force structure consultant, architecture & engineering services, etc.):

Current fiscal year (2011): \_\_\_\_\_;  
Fiscal year 2010: \_\_\_\_\_;  
Fiscal year 2009: \_\_\_\_\_.

Aggregate dollar value of federal contracts held:

Current fiscal year (2011): \_\_\_\_\_;  
Fiscal year 2010: \_\_\_\_\_;  
Fiscal year 2009: \_\_\_\_\_.

**Federal Grant Information:** If you or the entity you represent before the Committee on Armed Services has grants (including subgrants) with the federal government, please provide the following information:

Number of grants (including subgrants) with the federal government:

Current fiscal year (2011): \_\_\_\_\_;  
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Fiscal year 2009: \_\_\_\_\_.

Federal agencies with which federal grants are held:

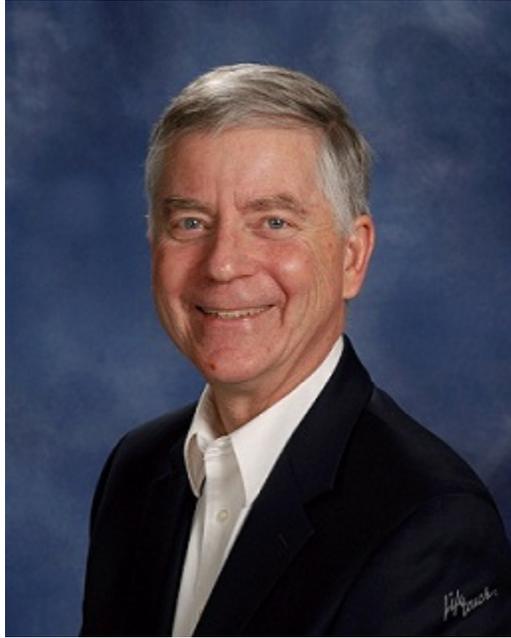
Current fiscal year (2011): \_\_\_\_\_;  
Fiscal year 2010: \_\_\_\_\_;  
Fiscal year 2009: \_\_\_\_\_.

List of subjects of federal grants(s) (for example, materials research, sociological study, software design, etc.):

Current fiscal year (2011): \_\_\_\_\_;  
Fiscal year 2010: \_\_\_\_\_;  
Fiscal year 2009: \_\_\_\_\_.

Aggregate dollar value of federal grants held:

Current fiscal year (2011): \_\_\_\_\_;  
Fiscal year 2010: \_\_\_\_\_;  
Fiscal year 2009: \_\_\_\_\_.



## About the President

Bradford L. Smith, Jr. is the President of Strategic Analysis, Inc. Mr. Smith provides systems engineering and analytical studies in the areas of future military systems concepts, long-range defense strategy development and planning, defense technology base management, and analysis of international technology transfer.

Mr. Smith has technical experience and expertise in electro-optics/infrared sensors, radar systems, acoustic sensors, computers and microelectronics, non-acoustic anti-submarine warfare (ASW) sensor technology, and advanced signal processing. He has led studies on advanced signal processing and aerospace technologies for the Office of the Secretary of Defense and has performed a variety of analytic efforts for the Defense Science Board.

From 1969 - 1973, he served in the US Army with the US Army Security Agency, Arlington Hall Station, VA and with US Forces Korea, Seoul, Korea.