Sequestration: Likely Effects on Federal Contracting and Strategies to Mitigate its Impact

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Agenda

- Sequestration: What is it?
- What sequestration means for federal contractors.
- Strategies to mitigate the impact of sequestration.

What is Sequestration?

- Budget showdown in 2011 resulting in …
- Budget Control Act of 2011
- The math is simple; the implementation is not
- $1 trillion automatic spending cuts over 9 years (2013-2021), or $110 billion/year
- Split between Defense and non-Defense
- A way to outsource congressional self-control

Coordinated Statements re: "Fiscal Cliff" (Nov. 9)

- House Speaker Boehner: "[The House's framework of targeted spending cuts and extending tax cuts for one year] can lead to common ground, and I hope the president will respond today in that same spirit. … I'm hopeful that productive conversations can begin soon so that we can forge an agreement that can pass the Congress."

Coordinated Statements re: “Fiscal Cliff” (Nov. 9)

- President Obama: “I’m not wedded to every detail of my plan. I’m open to compromise. I’m open to new ideas. I’m committed to solving our fiscal challenges, but I refuse to accept any approach that isn’t balanced.”

Sequestration's Mechanics – The $110 billion/year

- Defense: $55 billion from discretionary spending reductions
- Non-Defense: $39 billion from discretionary spending; $16 billion from entitlement programs

Sequestration Mechanics FY2013 and Beyond

- FY 2013 sequester takes automatic reductions from each non-exempt account
  - BCA calls for cuts to be evenly distributed across program, project and activity levels, but no common understanding of PPA
- FY2014-FY2021 sequestration takes form of lower spending caps on amounts that may be appropriated, allowing more targeted reductions

Sequestration's Current Effects – Survey Responses

- Federal Belt Tightening Takes Many Forms
  - Unexercised options (3); ID/IQ min. orders (1)
  - Partial Terminations (1) & Deductive Changes (1)
  - Insourcing (4) & Canceled solicitations (2)
  - LoF Clause; working "at risk" (3)
  - Gov't demanding lower prices regardless of rationale
  - Slowdown strategies: delayed awards, delayed NTP, partial funding

Sequestration's Current Effects – Survey Responses

- 9 of 20 respondents report their company has taken action in anticipation of sequestration or shrinking federal budgets
  - Discussions with customers to determine impact to existing and new work (1)
  - Personnel actions (5): lay-offs (actual and planned); cancelled hiring plans; hiring freeze
  - Cost cutting: reduced leased space (more telecommuting), less travel, more web meetings

Sequestration’s Early Effects – RJO Observations

- Bid Protest Activity
- Use of LPTA procurement vehicle
- Insourcing

Sequestration’s early effects; Industry Publications

- Increased price competition
  - Contractors bidding on contracts to add contribution margin, *i.e.*, bidding on more contracts at smaller margins
  - Mid-tier contractors squeezed between large companies going down market in search of new business and socioeconomic set-aside goals for small businesses
- Cutbacks on discretionary outlays: travel, training, R&D, leasing

Strategies to Mitigate the Impact on Contractors

- External Strategies – You and Your Customer
- Admit challenges and address them
  - Preferable to awaiting unilateral contract action
- Stay in close contact with your customers
  - Better understand what programs the customer considers central to its mission & emphasize your contracts' role in achieving that mission
  - Mine agency for information on plans for your contracts

Mitigation Strategies

- Internal Strategies – Preparing Your Company
- Inventory your federal contract portfolio to assess vulnerability to cuts
  - Location of contracts in lifecycle
    - Large unfunded amounts? (Most attractive to agencies)
  - Review major subcontracts and teaming agreements to determine rights if work is reduced or eliminated

Mitigation Strategies continued

- Identify contracts by type
  - Cost-type contracts will be vulnerable to reduced billings
  - Supply contracts vulnerable to convenience terminations or changes
  - Construction projects may be slowed to delay payment milestones

Mitigation Strategies continued

- Stay alert for opportunities
  - Stay current on equitable adjustment and other claims and file them sooner rather than later
  - Speed up work and timely submit invoices
  - Identify contracts to which work may be added if a competitor’s contract is cut or option not exercised
  - Can assets be redeployed to commercial work?

Mitigation Strategies continued

- Maximize performance & update performance ratings
  - Agencies will be forced to pick and choose which contract to trim
  - Companies that consistently perform on-time and on-budget will better weather the storm
  - Don’t give agencies an excuse to take an adverse action on your contract

Partial Terminations vs. Deductive Changes

- How a deletion of work is characterized may be critical to determining recovery
- Inherent tension between agency and contractor
- Opportunity to bargain
- No clear rule for determining how to characterize a deletion of work

Recovery Rules – Termination for Convenience

- Termination for Convenience (FAR 52.249-2)
  - Equitable adjustment to contract price that has a moderating effect on profit or loss
    - On profitable contracts, contractor allowed a “reasonable” profit
    - On money-losing contracts, contractor can avoid taking additional losses on deleted work
  - Recovery of post-termination expenses
- Preferable for contracts in loss position or at near break-even

Recovery Rules – Deductive Changes

- Deductive Changes (FAR 52.243-1)
  - Reduces price by cost of work deleted and profit attributable to that work
    - On profitable contracts, contractor can bank its profits on performed portion of contracts
    - On money-losing contracts, contractors takes full brunt of expected losses
- Preferable for high-margin contracts

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