

COVID-19 and the Defense Budget and Defense Supply Chain

April 27, 2020

Featuring: Andrew Hunter (CSIS)
Mackenzie Eaglen (AEI), and Todd Harrison (CSIS)

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Defense Supply Chain and COVID 19

Andrew Hunter

Director of DIIG & Senior Fellow, International Security Program

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International
Security Program

Emerging Issues for Defense Supply Chains

- COVID Disruptions & Economic Sudden Stop
- Trade Flow Disruptions
- Trade and Travel Restrictions
- Other Supply Chain Challenges

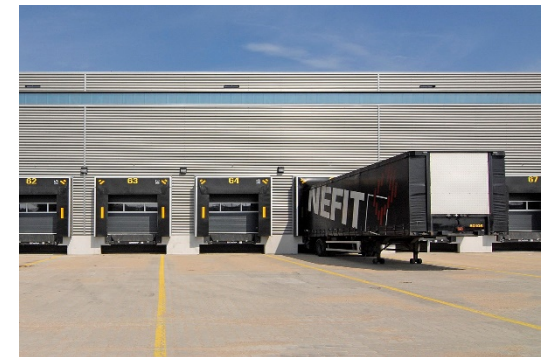
COVID Disruptions & Economic Sudden Stop

- US Defense Industry Operating as Critical Infrastructure but Production Slowed with Workers on Leave
- DOD Keeps Buying & is Accelerating Payments, but Deferring Delivery & Costs will Grow
- 60%+ Decline in US Air Travel (per IATA)
- Commercial Aircraft Production Gapped & Purchases/Deliveries Deferred
- Automotive Industry Plants Idled



Disruptions in Trade Flow

- Containers Piling up at Marine Terminals
- Distribution Warehouses Full or Closed
- Flow of Containers Disrupted (Containers stranded)



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International Trade and Travel Restrictions

<u>Issue</u>	<u>Status</u>	<u>Impact</u>
• Border and Travel Restrictions	• 150 countries have adopted including US for Mexico & Canada Borders	• Complicates movement of goods across borders
• Export Restrictions	• More than 50 countries have restricted exports of Medical Equipment, Supplies, & Food	• Expanding state involvement in commercial supply chains & potential for retaliation
• Disparate Industrial Policy	• Other countries may not designate defense industry as critical	• Closure of key overseas production facilities that supply US defense industry

Source: CSIS Analysis

CARES Act Implementation

- DoD Issues DFARS Class Deviation April 8, 2020 on CARES Act Implementation (Section 3610)
- Department of Treasury issued guidance on CARES Act assistance (Section 4003) to national security businesses on March 30



Other Supply Chain Challenges

- Will increased export controls and reduced licensing capacity due to work from home cause delays in processing exports and imports?
- How and when will Sec. 889 limitations on contractor supply chains and support services be implemented and how much will this further disrupt global supply chains?
- How will DoD track industrial shutdowns among suppliers, especially those who don't know they are “defense industry,” e.g. freight forwarders?

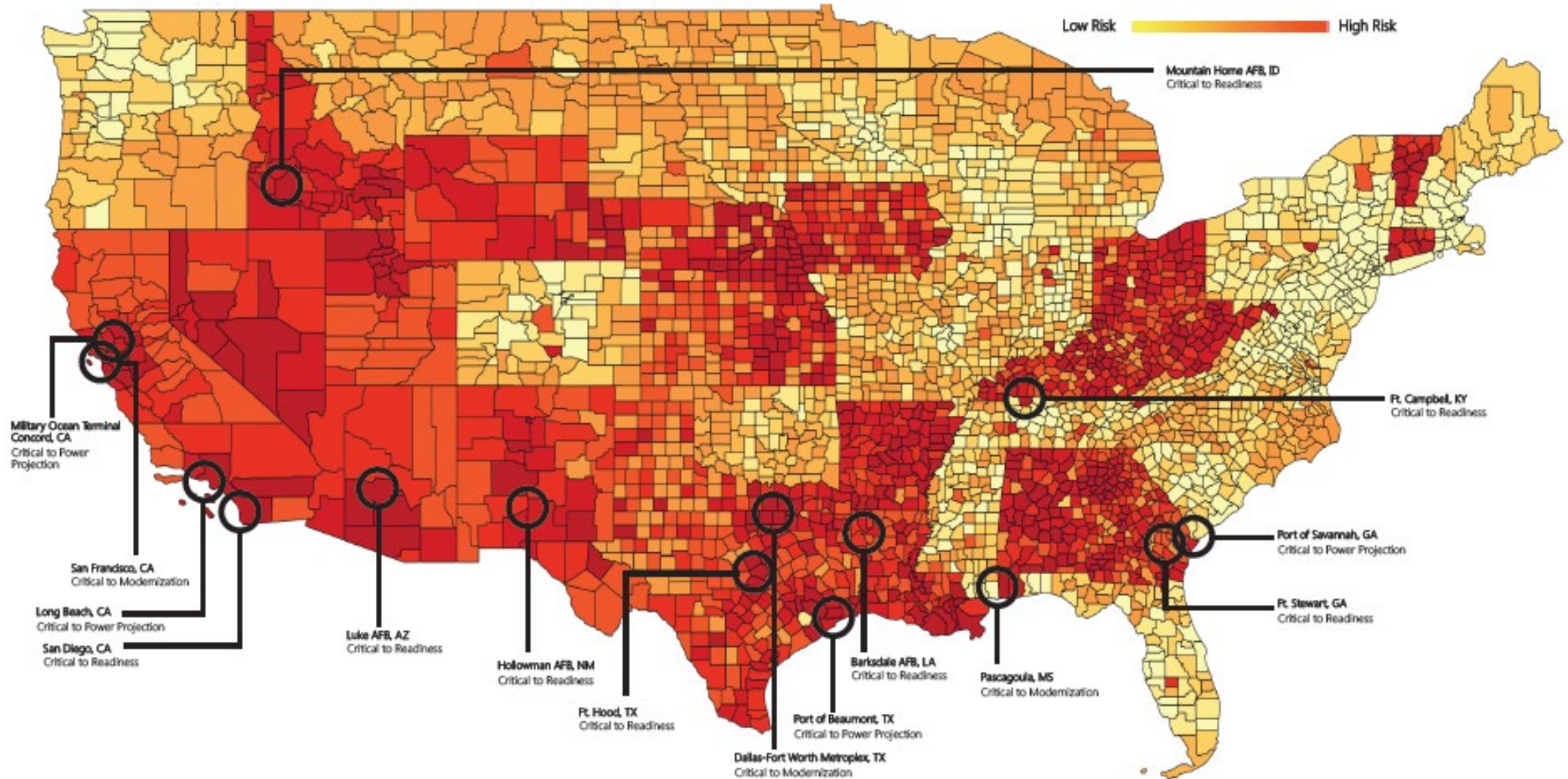
COVID-19 & The Defense Industrial Base Uncertainty and Delays

Center for Strategic and International Studies
April 27, 2020

Mackenzie Eaglen
Resident Fellow
American Enterprise Institute



High Risk Place of Performance Locations



Source: Govini, "[COVID-19 Impacts on the Department of Defense](#)," April 2020.

- “Respondents expect the COVID-19 crisis to have the biggest impact on their **revenue expectations**, followed closely by their ability to **perform on a contract** and their **access to capital**.”
- “**62 percent** of small businesses have experienced a **disruption in cash flow** as a result of the COVID-19 crisis. Most commonly reported causes are cuts to billable hours, delayed payments from primes contractors and government customers due to a shutdown or telework, and a lack of options or schedule flexibility in contracts.”
- “**30 percent** of respondents expect to experience overruns in their fixed price contracts as a result of COVID-19 crisis; those that expect cost overruns expect at 10-20% overrun.”
- But, “**69 percent** of respondents **do not expect to experience overruns** on fixed price contracts as a result of disruptions caused by COVID-19.”
- “**54 percent** of small businesses have experienced a disruption in their ability to perform on a contract as a **result of a shelter-in-place order** related to the COVID-19 outbreak.”
- **Helpful Solutions:** companies rated “flexibility being granted on the performance of your contract(s) [as] the most helpful” solution, with other options including accelerated payments from the DOD and prime contractors, short-term loans being made available and additional guidance being provided on the performance of contracts.”

- On April 20, **Ellen Lord** reported that Out of 10,509 major prime companies, 106 are closed, with 68 companies having closed and reopened. Out of 11,413 vendor-based companies, 427 are closed, with 147 having closed and reopened.
- **Jennifer Santos** holds four industry calls per week with 18 associations representing over 3 million companies.
- **Govini** has reported that there are roughly 50,000 small businesses that provide innovation support to the DoD, all of which are vulnerable to economic upheaval.

Joint Acquisition Task Force (JTAF)

- Ellen Lord established the **Joint Acquisition Task Force** in March. **Stacy Cummings** is the head of JTAF and she “has the authority to leverage the services’ and agencies’ acquisition resources to support the acquisition execution of the DOD COVID response.”
- JTAF is responsible for directing the **Defense Production Act** authorities and funding in response to the immediate crisis.
- Responsibilities include “building capacity in identified areas of fragility in the **defense industrial base**, both the industrial capability and workforce, with a focus on **reducing reliance on foreign supply sources.**” (Ellen Lord, March 25)

Progress Payments

- On March 20, **Kim Harrington** issued a memo increasing progress payment rates for contracts from **80 percent of cost to 90 percent for large business** and from **90 percent to 95 percent for small businesses**.
- Over 20 other memos have been issued by Kim Harrington in response to the crisis.
- As of April 20, Director of the Defense Contracting Management Agency (DCMA) has modified **1,500 contracts** to help companies file invoices at the higher progress payment rate.
- Kim Harrington has announced **\$3 billion** in progress payments **to prime defense contractors**. To date, no system has been set up to audit how this money is spent, though the DOD has auditing functions in all of its major contracts.
- [Lockheed Martin](#) has announced that it will flow an estimated **\$600+ million** in **accelerated payments** to its supply chain partners.

Office of Small Business Programs

- **Office of Small Business Programs** continues to work closely with the services and **Small Business Administration**.
- Both the Army and Navy have increased the rate of obligations to small-business concerns, obligating an additional **\$180 million per week** above their normal spending since mid-February, which equates to a **26 percent** increase from the previous year.

Contracting Actions – Section 3610 of the CARES Act

- Kim Herrington told defense acquisition workers that under **Section 3610 of the CARES Act, the government can modify contracts to ensure vendor employees are paid when they can't work.**
- Caveats: vendors can't "double dip" in relief programs. If a small business receives money from the Paycheck Protection Program, it cannot receive money from the DoD as well.
- The DoD isn't mandated to pay contractors, but it's an option.

Other Transaction Authority

- On April 5, Ellen Lord issued a [memo](#) to expand the use of Other Transaction Authority (OTA) agreements for coronavirus programs up to **\$100 million for prototypes and \$500 million for follow-on production agreements.**

Equitable Adjustment Guidance

- On March 30, Kim Herrington signed a separate memo on equitable adjustments for contracts.
- This memo "lets the military services and Defense agencies initiate the clauses in contracts that excuse performance delays, when the failure is beyond the control and without the fault or negligence of the contractor."
- When such a delay occurs, the contractor is entitled to an equitable adjustment of the contract schedule and cost, which means that the contractor will not default on their contract.

Service Acquisition Executives Respond



Army

- Increased rate of obligations to small businesses
- Set up a task force; Bruce Jette receives a list of potential issues within the supply chain every day
- NOTE: Sticking to future contract schedule, no accelerated contracts announced
- Some modernization projects pursued virtually (Army Futures Command)
- The Army's expeditionary technology search group has launched a challenge competition for low cost ventilators.
-

Air Force

- Increased rate of obligations to small businesses
- Shifted Air Force Pitch Days online; awarded nearly **\$1 billion in 599 small business contracts**
- Releasing **\$882 million** in payments to Boeing after holding back because of flaws in the KC-46
- Awarding contracts early
- Ensuring there are no progress payment lapses even if contracts need to be extended or follow-on ones awarded
- Called for consolidated USAF Space acquisition authority to move funds internally
- Held an emergency meeting of Space Acquisition Council to protect vulnerable suppliers

Navy

- Reducing retentions and withholds in contracts to the lowest amount possible under DoD guidelines
- **Paying all settled requests for an equitable adjustment (REAs)** immediately and resolving remaining REAs quickly
- Accelerating negotiations on future work
- Accelerating contract awards for stability (**+32% fast/larger total Navy contract awards** to date)
- Accelerating cash advances for supplier liquidity (largely complete)
- Using real-time tracking to look at hot spots to see what companies might be affected next
- Accelerating inventory out of plants that are in danger of being shut down
- Trying to "double-down" on **S&T funding**
- Accelerating **O&M-funded aircraft spare parts purchases** to absorb excess capacity of aerospace suppliers

Using the Defense Production Act (Title III)



- DPA Title III allows the federal government to incentivize the production and supply of critical materials, goods and technologies various tools, including:
 - **Direct loans**
 - **Loan guarantees**
 - **Direct purchases**
 - **Purchase commitments**
 - **Equipment installation**
- DoD announced its first DPA Title III COVID-19 project on April 11, awarding \$133 million to increase U.S. domestic N95 mask production by over 39 million in 90 days – the contract was split between the following companies:
 - 3M (\$76 million)
 - O&M Halyward (\$29 million)
 - Honeywell (\$27.4 million)
- However, Title III can be used to protect the defense contractor workforce more directly via targeting injections of funds to address the emergent needs to small businesses.
- For example, innovative firms and single-source suppliers could be directly targeted with funds via DPA Title III to help them weather the economic fallout from Covid.

Compliance/Registration (Registration Extensions)


- **International Traffic in Arms Regulations (ITAR)** registration **deadlines have been extended** for defense contractors.
- DDTC Compliance is **granting extensions on RFIs** related to voluntary and directed disclosure matters.
- DDTC is instituting a one-time temporary **reduction in registration fees** for certain categories of DDTC registrants.

Licensing (Speeding Up)

- Select ITAR licenses that are scheduled to expire between March 13 and May 31 have been **extended for six months**.
- Certain ITAR requirements for have been waived to **allow employees to work remotely**, as long as they are not located in Russia, or a country listed in ITAR 126.1. Certain **technical data** can also be accessed remotely.
- Unclassified final action letters will be sent via to contractors via email.
- DDTC is allowing **electronic submissions** of Congressional Notifications of proposed Direct Commercial Sales (DCS) and Foreign Military Sales (FMS) **to Congress**.

Management (More Efficiency)

- DDTC is accepting the electronic submission of FMS Part 130 reports.
- DDTC has added additional points of contact within its office for contractors.



COVID-19 Impacts on the Defense Budget

Todd Harrison

Senior Fellow and Director of Defense Budget Analysis

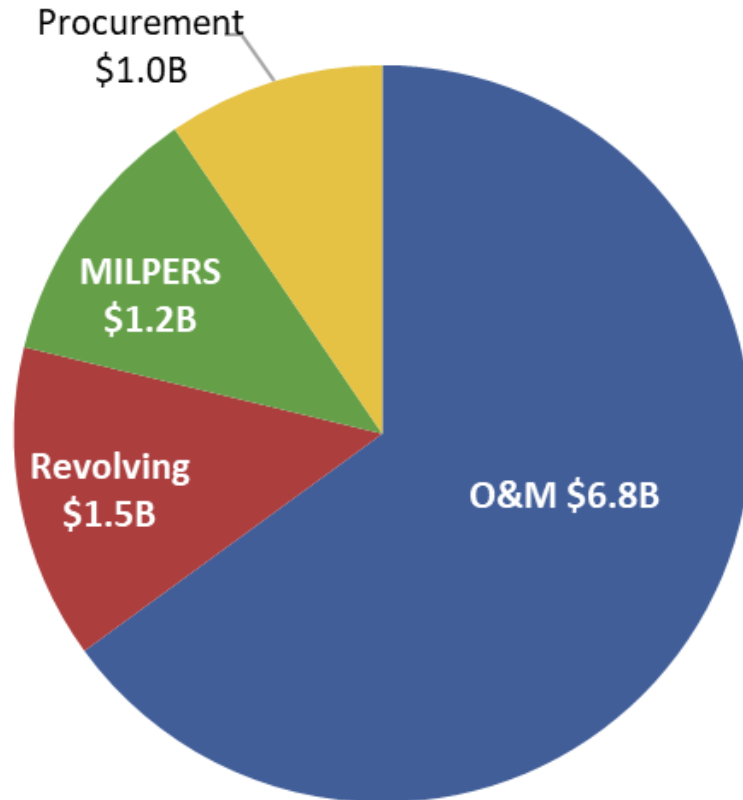
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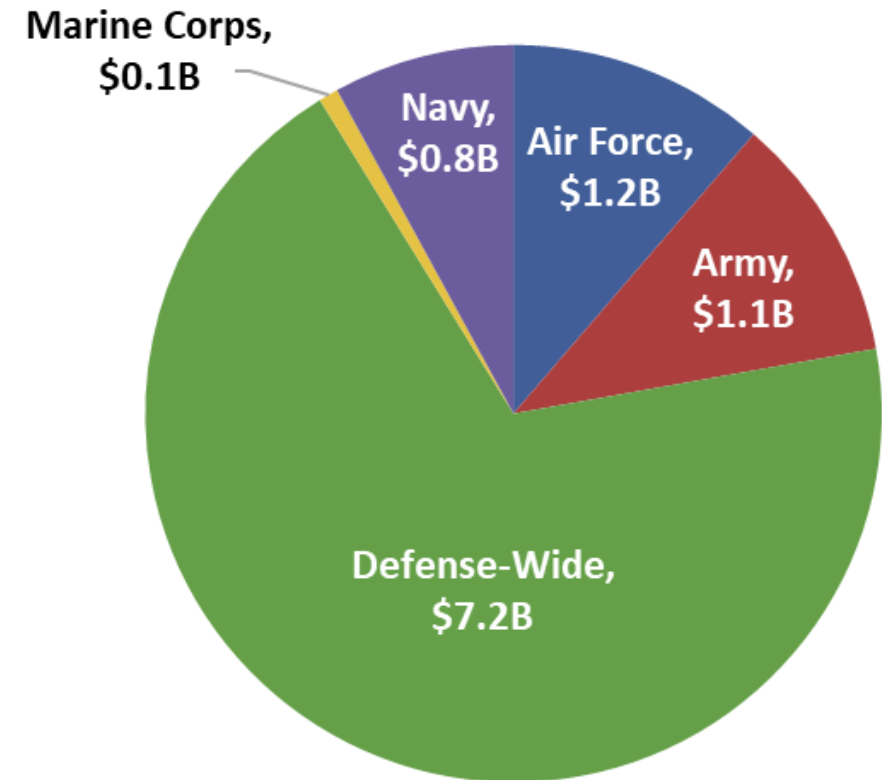
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\$10.5B in DoD Funding in the CARES Act

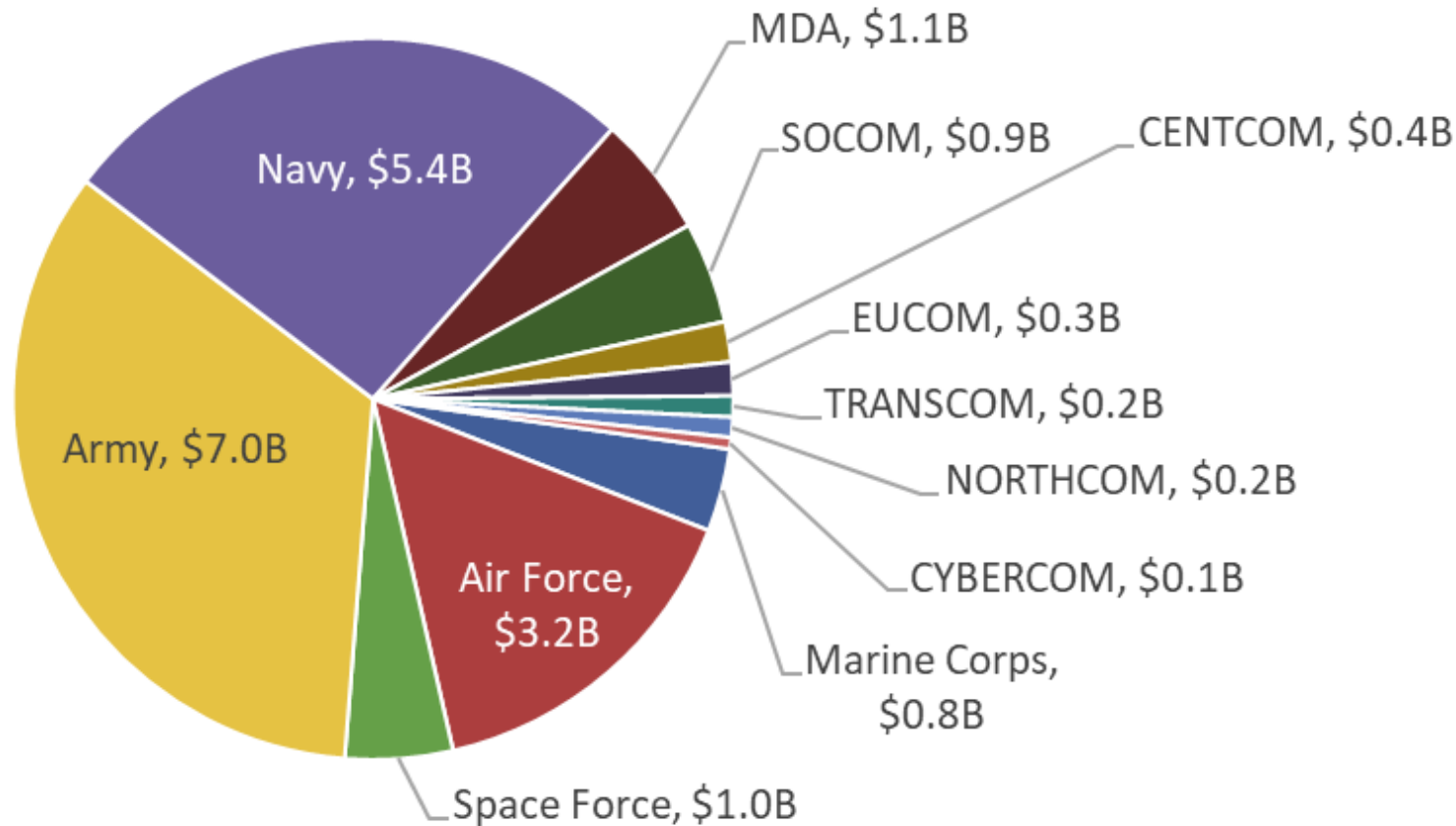
DoD Funding in the CARES Act by Title



DoD Funding in the CARES Act by Service

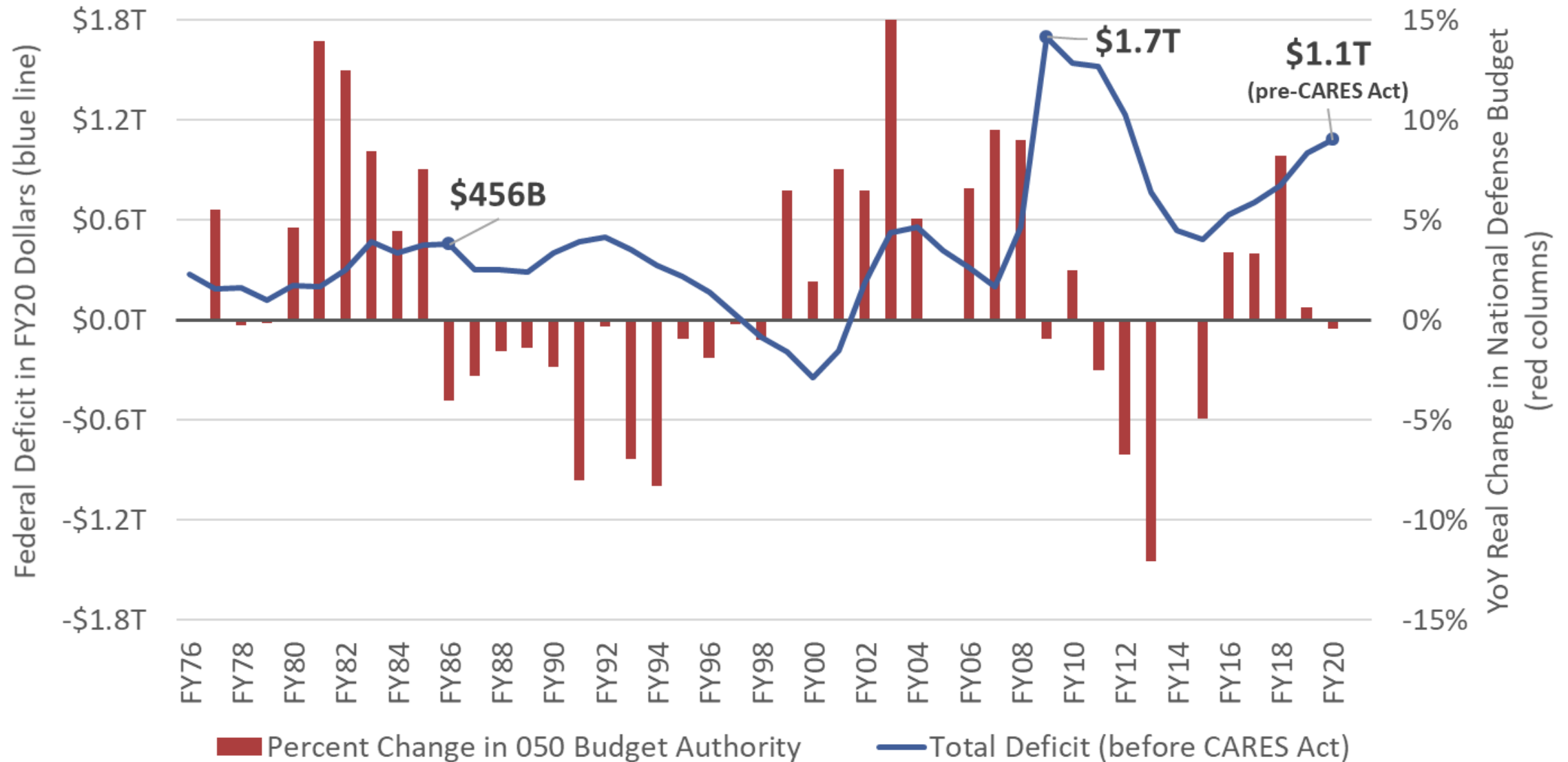


Additional Funding for DoD in Next Stimulus Bill?



- Initial indications are that OSD may ask for unfunded priorities to be included
- DoD could also request funding for:
 - Sec. 3610 implementation
 - MILCON / infrastructure
 - Readiness recovery

Defense Downturn Could Be Coming



Updated Deficit Projections

