

DEPARTMENT OF DEFENSE RELEASES REPORT ON STATE OF COMPETITION WITHIN THE DEFENSE INDUSTRIAL BASE

On February 15th, 2022, the Department of Defense ("DoD") Office of the Under Secretary of Defense for Acquisition and Sustainment released a 30-page report titled "State of Competition within the Defense Industrial Base" (hereinafter "Report").¹ The Report was required by President Biden's Executive Order 14036, *Promoting Competition in the American Economy* (the "Order"), where he tasked DoD to submit a report to the Chair of the White House Competition Council within 180 days discussing "the state of competition within the defense industrial base, including areas where a lack of competition may be of concern and any recommendations for improving the solicitation process, consistent with the goal of the Competition in Contracting Act of 1984."²

Coincidentally, the Report comes less than two days after Lockheed Martin abandoned its \$4.4 billion proposed acquisition of Aerojet Rocketdyne.³ The Federal Trade Commission ("FTC") sued to block the proposed merger on January 25th, 2022.⁴ The lawsuit and subsequent abandonment of the merger shows increased scrutiny for both horizontal and vertical mergers in the defense space.

BACKGROUND

The Report is laid out in three sections: Section 1 discusses the state of competition in the defense industrial base ("DIB"), including challenges and

¹ *State of Competition with the Defense Industrial Base*, Dep't of Defense (Feb. 2022), available at <https://media.defense.gov/2022/Feb/15/2002939087/-1/-1/1/STATE-OF-COMPETITION-WITHIN-THE-DEFENSE-INDUSTRIAL-BASE.PDF>

² *Executive Order on Promoting Competition in the American Economy* (July 9, 2021), available at <https://www.whitehouse.gov/briefing-room/presidential-actions/2021/07/09/executive-order-on-promoting-competition-in-the-american-economy/>

³ Press Release, *Lockheed Martin, Lockheed Martin Terminates Agreement To Acquire Aerojet Rocketdyne* (Feb. 14, 2022), available at <https://news.lockheedmartin.com/2022-02-13-Lockheed-Martin-Terminates-Agreement-to-Acquire-Aerojet-Rocketdyne>

⁴ Press Release, Fed. Trade Comm'n, *FTC Sues to Block Lockheed Martin Corporation's \$4.4 Billion Vertical Acquisition of Aerojet Rocketdyne Holdings Inc.* (Jan. 25, 2022), available at <https://www.ftc.gov/news-events/press-releases/2022/01/ftc-sues-block-lockheed-martin-corporations-44-billion-vertical>

recommendations related to mergers and acquisitions ("M&A"), intellectual property ("IP"), and the reliance on commercial items; Section 2 discusses the health of the small business DIB and provides recommendations to expand that base; and Section 3 provides a sectoral assessment across five priority areas, with recommended mitigations across each of these areas. The five priority areas are:

- Castings and Forgings;
- Missiles and Munitions;
- Energy Storage and Batteries;
- Strategic and Critical Materials; and
- Microelectronics

MAJOR THEMES

Consolidation

The Report addresses the relatively stable competitive environment for the DIB in logistics and maintenance bids but suggests that competition has declined significantly for major systems procurement. For example, DoD benefits from multiple potential suppliers for installation-level mission support and logistical requirements (e.g., food service, facility maintenance, grounds maintenance, and transportation services) and depot-level maintenance services requirements (e.g., contractor logistics support for spare parts). However, due to what the Report suggests has been massive industry consolidation for missile and weapon prime contractors, competition has lessened for major systems procurement (e.g., weapons and automated information systems), specialized equipment, and spare parts (especially for aging weapon systems). Furthermore, the Report highlights the sole-source risk that occurs when upgrades need to be purchased from the original equipment manufacturers or suppliers.

According to the Report, the number of aerospace and defense prime contractors shrank from 51 in 1990 to 5 in 2015, leaving Lockheed Martin, Raytheon, General Dynamics, Northrop Grumman, and Boeing as the only firms capable of supplying DoD with missiles and weapons systems.

DoD charts concentration in additional categories as outlined below.

Weapons Category	Total US Contractors			Current US Based Prime Contractors
	1990	1998	2020	
Tactical Missiles	13	3	3	<ul style="list-style-type: none"> Boeing Lockheed Martin Raytheon Technologies
Fixed-Wing Aircraft	8	3	3	<ul style="list-style-type: none"> Boeing Lockheed Martin Northrop Grumman
Expendable Launch Vehicles	6	2	2	<ul style="list-style-type: none"> Boeing Lockheed Martin
Satellites	8	5	4	<ul style="list-style-type: none"> Boeing Hughes Lockheed Martin Northrop Grumman
Surface Ships	8	5	2	<ul style="list-style-type: none"> General Dynamics Huntington Ingalls
Tactical Wheeled Vehicles	6	4	3	<ul style="list-style-type: none"> AM General General Motors Oshkosh
Tracked Combat Vehicles	3	2	1	<ul style="list-style-type: none"> General Dynamics
Strategic Missiles	3	2	2	<ul style="list-style-type: none"> Boeing Lockheed Martin
Torpedoes	3	2	2	<ul style="list-style-type: none"> Lockheed Martin Raytheon Technologies
Rotary Wing Aircraft	4	3	3	<ul style="list-style-type: none"> Bell Textron Boeing Lockheed Martin (Sikorsky)

Smaller Business Involvement

The Report further indicates that DoD has attempted to increase the number of participants in the DIB by spending more time and funding to bolster smaller businesses. In 2021, DoD spent \$80.3 billion on small businesses, and in the last 10 years, has increased small business spending by 83%. Despite this increased spending, the number of small businesses in the DIB decreased 40%. If that trend continues, Deputy Secretary of Defense Dr. Kathleen H. Hicks believes that DoD could lose an additional 15,000 suppliers over the next 10 years.

Labor Market

Here, the Report notes that DoD is concerned with workforce constraints and shortfalls, specifically for middle to highly skilled workers, and their impact on U.S. national security. For example, when highly skilled workers move out of the defense supply chain, the Report claims they are difficult to recruit back and costly to retrain. This shortage of expertise, along with consolidation and reduced competition amongst prime competitors, "frustrates DoD's ability to compete in the

labor market, both for broadly needed manufacturing skills and for workers with critical defense specialty skills."

Missiles and Munitions

Of the five priority areas, the section discussing missiles and munitions appears to be the biggest vulnerability to national security, according to the Report. It observes that over the last three decades, the number of missile prime contractors has reduced significantly, leaving only large companies with "established brand identities and strong holds on cumulative experience, proprietary designs, and technology." The Report further explains that as the cost to enter the market is higher than any other sector, especially due to the safety requirements and facilities needed, it is nearly impossible for new entrants to enter the missile and munition markets. DoD states that it fears these substantial costs will lead to the major prime contractors acquiring lower-tiered hypersonic component and material subcontractors, which could lock up essential parts from competitors and potential new entrants. When only one company is available, the government must sole-source contracts. This was recently seen when DoD had to sole-source the high-dollar Ground Based Strategic Deterrent ("GBSD") award to Northrop. Boeing dropped out of the GBSD contract, claiming that Northrop's acquisition of Orbital ATK created an unequal playing field for GBSD.

RECOMMENDATIONS

The Report lays out five broad recommendations to spur competition in the DIB:

- *Strengthening Merger Oversight.* DoD faces a historically consolidated DIB, making heightened review of any further M&A necessary. Moreover, when a merger threatens DoD interests or the DIB, DoD will support the FTC and Department of Justice Antitrust Division in antitrust investigations and recommendations.
- *Addressing IP Limitations.* IP and data rights limit competition by awarding the prime contractor with exclusivity, which has negative impacts for DoD (e.g., "vendor-lock"), even in instances where DoD funded or reimbursed most of the innovation stages. DoD will implement best practices for identifying its long-term IP needs early in the competitive phases of acquisition programs, ensuring that IP is an evaluation factor in competitive awards and a negotiation objective in sole-source awards, and contracting with vendors who are willing to provide the government with the IP deliverables and rights it needs. In its ongoing modernization of its approach to IP rights, DoD should do what it can to create IP-related procedures that do not result in unnecessary anticompetitive consequences.
- *Increasing New Entrants.* To counteract the contraction of the DIB, DoD should endeavor to attract new entrants by reducing barriers to entry. This will be accomplished through small business outreach, support, and use of acquisition authorities, like other transaction ("OT") authority and commercial solutions opening ("CSO"), that provide DoD the flexibility to

adopt and incorporate commercial best practices to reduce barriers and attract new vendors.

- *Increasing Opportunities for Small Businesses.* DoD should increase small business participation in defense procurement, with an emphasis on increasing competition in priority industrial base sectors.
- *Implementing Sector-specific Supply Chain Resiliency Plans.* DoD should take steps to ensure resiliency in the supply chain for five priority sectors: casting and forgings, missiles and munitions, energy storage and batteries, strategic and critical materials, and microelectronics. Detailed recommendations are included in DoD's report on Executive Order 14017, *America's Supply Chains*.

KEY TAKEAWAYS

First, the Report focuses on how consolidation in the DIB can harm competition and weaken U.S. national security; however, the articulation of actual harm seems somewhat tenuous. Notably, the Report does not find a strong correlation between consolidation and increased program pricing, but highlights other unquantified risks, such as a reduction in the availability of key supplies and equipment, diminished vendor incentives for innovation and performance in government contracts, and supply chain vulnerabilities. Later, the Report conversely suggests that consolidation has "in some cases, led to improvements in corporate efficiency, product quality, or internal costs." Unlike the Treasury Department's recent report on beer, wine, and spirits, the Report does not provide statistical data that shows harm due to a lack of competition, such as price increases. It also references private equity roll ups twice without specifically mentioning any companies or harms resulting from these roll ups.

Second, the elevation of IP and data rights as a determining procurement factor may give certain contractors some pause. Maintaining exclusive IP rights is often a primary motive for firms to embark on large investments of time and expertise to innovate in the space. Any dilution of those IP rights, as DoD is considering, may cause a chilling effect and further decrease the number of firms willing to compete.

Third, while the Report cites a lack of prime contractors and middle to highly skilled workers, it seems to neglect the security and operational knowledge requirements that are needed to adequately serve DoD. Adding additional companies and workers to the DIB creates its own national security risks.

Fourth, this may be the agency's first public recognition that the Northrop Grumman-Orbital ATK merger, which Boeing publicly denounced, caused Boeing to no-bid in the GBSD program. That prior merger and the parties' compliance with the FTC's consent decree, which was completed in 2018, is currently under investigation by the FTC's Compliance Division.

Finally, this Report is just one of many that is required by President Biden's Order. Last week, the Department of the Treasury released its report titled "Competition in the Markets for Beer, Wine, and Spirits." Other agencies tasked by the Order include the Departments of Agriculture, Health and Human Services, Commerce, and Transportation.

CONTACTS

Timothy Cornell
Partner

T +1 202 912 5220
E timothy.cornell
@cliffordchance.com

Peter Mucchetti
Partner

T +1 202 912 5053
E peter.mucchetti
@cliffordchance.com

Sharis Pozen
Partner

T +1 202 912 5226
E sharis.pozen
@cliffordchance.com

Brian Concklin
Counsel

T +1 202 912 5060
E brian.concklin
@cliffordchance.com

Jordan Passmore
Associate

T +1 202 912 5416
E jordan.passmore
@cliffordchance.com

Elyssa Wenzel
Law Clerk

T +1 202 912 5975
E elyssa.wenzel
@cliffordchance.com

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www.cliffordchance.com

Clifford Chance, 2001 K Street NW,
Washington, DC 20006-1001, USA

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