

Testimony on behalf of the Mid-Tier Advocacy/ Developing Second-Tier Small Business Association (MTA/DSTSBA), the Latin American Management Association (LAMA) and the National Federal Contractor's Associations (NaFCA)

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Minority Contracting: Opportunities and Challenges for Current and Future Minority-Owned Businesses

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Madam Chairwoman, and members of the committee, I am honored to come before all of you today to represent Mid-Tier Advocacy/Developing Second-Tier Small Business Association (MTA/DSTSBA) and its strategic partners, the Minority Business Roundtable (MBRT), the Latin American Management Association (LAMA), Business Enterprise Legal Defense and Educational Fund (MBELDEF) and National Federal Contractor's Associations (NaFCA), to provide insight into what we refer to as "the twilight zone," the competitive quagmire in which many firms that have outgrown the NAICS revenue/employee ceilings (second-tier firms) find themselves due to being neither small enough nor large enough to successfully compete in the federal market place. These businesses are quite literally between a rock and a hard place and therefore some face the threat of going out of business altogether. This disparity is a critical issue that affects the very health and vitality of our national economy.

The DSTSBA directly and indirectly represents a community of small and developing second tier firms that provide employment for thousands of people across the United States and across multiple industries including, but not limited to, information technology, engineering, logistics, facilities management, operations and maintenance, international development, scientific research, resource management, construction and more in support of both the public and private sectors. As an organization of the country's top veteran-owned, service disabled, hub-zone certified, minority-owned and woman-owned businesses, we believe that most concerns are well represented as it pertains to small business.

In the last 40 years, the federal government has had a significant positive impact on the development of small businesses in our country. The Department of Commerce, through the office of Minority Business Development Agency, has contributed to the significant growth in our economy through its network of centers throughout the US; assistance with securing financing, and identifying and accessing opportunities. Important to note are also the contributions to expand the United States economic base with fundamental support to small business by the Small Business Administration (SBA) and its' numerous programs, particularly in the areas of federal procurement. Singularly, the 8(a) program has done more for the development of minority-owned firms than any other government-run program to date. These

programs have served to support minorities, entrepreneurship, and small businesses and have been a success story to date.

However, Madam Chairman and members of the committee, thousands of minority businesses have disappeared from the landscape of the federal marketplace over the last three decades. The policies that drive the management of size-standard criteria help the entry-level and emerging minority firms; however, the same policies that make it possible for start-up firms to succeed, also eventually stifle many of them after achieving some modest success in the federal marketplace and outgrowing their small-business status. As a consequence, a significant number of minority and small businesses are faced with the decision of either selling their companies at less than desirable terms to large corporations, or going out of business altogether. Minority and small business entrepreneurs, like most, prefer to grow their businesses in order to increase value for themselves and their families, as well as their employees.

The Challenges Developing Second-Tier Firms Face Today

Our testimony today will focus on 1) Restrictive Size Standards; 2) In-sourcing, a rising challenge; 3) Large businesses become small through acquisition; and 4) Infrastructure capacity. Of these challenges, we will emphasize Restrictive Size-Standards because it is the main roadblock for the Developing Second Tier Firm and it is the main goal of the Mid-Tier Advocacy group. We will make several recommendations as I summary of the briefing. Now I will start with a discussion of the current and, as we believe, inadequate standards used to define small-business by the National American Industry Classification System (NAICSⁱ). We say “inadequate” because in most cases the NAICS codes define small business in the federal market place as a company or corporation that has less than a certain threshold in annual revenues over a three year average. For instance, a business that specializes in training, qualifies as small if it has a three-year average sales of \$7M and in information technology if it sells fewer than \$25M. The reality is that once any company surpasses this standard, it is considered “*other than small*”.

In practice, however, these are not really “large” companies; they simply no longer meet the traditional small business size-standards. Once this point is reached, any such business, even if it

only has \$8M per year in sales in the training industry, has to directly compete with the top six federal government systems integrators Northrop Grumman, Lockheed Martin, SAIC, EDS- Hewlett Packard, and General Dynamics with average sales of \$30B per year and 130,000 employees (see Tables 1 & 2 below). Developing second-tier firms cannot realistically be expected to compete with such corporations?

Table 1

GRAPHICAL VIEW OF SMALL BUSINESSES COMPETITION AGAINST LARGE BUSINESSES DAVID v GOLIATH					
LARGE SYSTEM INTEGRATORS		SMALL SYSTEM INTEGRATORS		LARGE SYSTEM INTEGRATORS	SMALL SYSTEM INTEGRATORS
Company Name	Annual Revenue in BILLIONS	NAICS Ceiling on Revenue in MILLIONS		Number of EMPLOYEES	NAICS Ceiling on EMPLOYEES
Northrop Grumman	\$33.8	\$7 – 33.5M		120,000	500 - 1500
Lockheed Martin	\$45.189			136,000	
General Dynamics	\$31.981			91,200	
EDS (not part of HP)	\$22.1			136,000	
CSC	\$16.740			95,000	
Average	\$29.962			130,040	

Madam Chairman, the above table clearly demonstrates how illogical, even ludicrous, the federal policy on size-standard is as it relates to the ability of minority entrepreneurs to protect and further develop their businesses. To make this point even more clearly, let us assume the above

sales standards were three times what they currently are: Instead of a \$7M ceiling, the NAICS small-business restriction would now be \$28M and instead of \$25M, the restriction would be capped at \$100M. The sales differential between a large corporation and a Developing Second Tier business would still be nearly \$ 29.934B and \$ 29.862B respectively – almost \$30B. With such a stark difference, how is it possible that two such businesses, in all fairness can be put in competition with each other?

When companies like my own do compete against these giants, we have very little chance of success. I started my own business, THE CENTECH GROUP, in 1988 with the help of the 8(a) minority small business development program. As of last month, CENTECH successfully performed on over 4,200 contracts in the federal marketplace, and reached aggregate revenue of 1 billion dollars over 22-years. Our current annual revenue at CENTECH now stands at about \$150M.

At face value, this performance may seem impressive, however, Madam Chairman and members of the committee, in the last 18 months, our company has had very little success in competing against the big corporations despite being graded as technically acceptable by the government. To be specific, in June 2009, we had 410 employees; today we have 280 employees. This is the direct result of having to compete with large corporations with thousands of employees and significant resources, giants compared to our humble size. In the last few months, we have lost three of our incumbent contracts on which we performed for over 10 years to very large corporations who can offer pricing which we simply cannot compete against. This experience of loss is shared by hundreds of other minority small businesses trying to compete in the U.S. federal marketplace.

The fact remains, that doing business in the federal market place is very different from doing business in the commercial sector. Businesses in the federal market place are limited by Government requirements on yearly submissions of G&A budgets to be approved by the Defense Contract Audit Agency. These budgets define the amount of money a business can utilize for its growth expenses. For example, if a business with a 10 percent G&A budget and sales of \$1M will have a \$100,000 G&A with which it must cover all of its corporate management costs,

including accounting and finance, HR, contracts administration, security risk management, quality assurance, internal logistics and business development (sales representatives and proposal development). To compare, a \$25M firm with a 10 percent G&A budget will have \$2.5M to cover the same functions. This, to an inexperienced business person might appear to be an abundant sum to operate such a firm. But consider the cost of qualified management personnel in the federal market place as reflected in the following annual base salaries:

CFO	\$175,000
Director of Administration	\$125,000
Chief Technical Officer	\$150,000
Business Development Manager	\$175,000
Business Development Specialist	\$120,000
HR Director	\$120,000
Contracts Administrator	\$135,000
Quality Assurance Manager	\$120,000
Total	\$1,120,000

The above salaries are estimated at the lower end of the competitive range. To this, we must add fringe benefits and overhead costs:

Benefits (35 percent)	\$392,000
Overhead (25 percent)	\$378,000
Total	\$1,890,000

According to this model, just the leadership costs for a \$25M business amounts to \$1.89B, leaving only about \$600,000 of the \$2.5M budget. This sum must pay for staff support in accounting and finance, HR and project operations support, business development and proposals and of course, the owner, or CEO, who is leading the organization.

Developing Second-Tier firms providing goods and services to the federal government experience many challenges, but today our testimony focuses the main ones: 1) Restrictive Size-Standard Policy; 2) Subcontracting 3) Large businesses become small through acquisition; and 4) In-sourcing, a rising challenge 5) Infrastructure capacity.

Restrictive Size-Standard Policy: Unintended cap on small business development

Developing Second-Tier firms lose **all** of the contracting incentives provided under the Small Business Programs. It is unfair and unreasonable to expect a Developing Second-Tier firm with sales ranging from \$50 - \$300 million to go into a “full and open” competition with government contractors whose sales range from \$10 B to \$171B. The NAICS revenue and employee definitions for small firms actually create a ceiling for small businesses. Most small businesses provide *services* with the most common NAICS ceiling set at \$7M and “the highest annual receipts size-standard for any service industry is \$35.5M.”ⁱⁱ

In the fully competitive world, Developing Second-Tier firms have few bidding options--- full and open contracts where the probability of a win is very small; or they can align with small businesses and bid as a subcontractor; or they can form a joint venture with a small business(es). The subcontract strategy and the joint venture strategy both limit the growth potential of Developing Second-Tier firms.

Small businesses grow beyond the limits set by the NAICS codes-, are in fact punished for doing what any business aims to do and that is to grow. Once they become moderately successful in the federal market place, they are thrust into the unrestricted labor market without the infrastructure and capital to compete successfully against *significantly* larger businesses. They are therefore in the twilight zone, a competitive quagmire. Consider the viability of an \$8M business competing against a \$30B corporation. While such an occurrence would generally be considered illogical, it happens in the federal sector on a daily basis. As a positive, the unprecedented growth in the size and number of federal contracts restricted to small businesses is providing tremendous growth for small businesses, accelerating the time required to graduate from small business status and, unfortunately, as a negative, simultaneously accelerating the point at which small businesses are no longer able to effectively compete.

Recommendations for Correcting Restrictive Size-Standards

First, we recommend suspension of the current revenue standards for small business determination in favor of using only an employee size-standard as is already used, for instance, in the telecommunications and telephone support industry, where a business is still considered

small if it employs fewer than 1,500 people, regardless of its three-year average sales. In those industries where a size-standard has not been identified, we recommend using a size-standard of 1500 employees. Several economists have concluded that average revenue is an *inappropriate measurement of business size*. For example, many of the contracts awarded to small businesses are for provision of supplies, and value added reselling. These contracts provide only a small profit margin, but have the potential to rapidly increase the businesses revenue stream and thereby accelerate its graduation to the unrestricted or “full and open” category. Similarly, small businesses that serve as prime contractors on supply and value added resale contracts are credited with the total revenue expenditure for that contract. However, in reality the small business must partner with other small and large businesses to successfully compete on these types of contracts and must disperse a considerable amount of revenue to subcontractors. The amount of monies dispersed to subcontractors can be as much as 80% of the total contract value which only leaves 20% for the prime, but 100% of the revenue gets added to prime contractor revenues.

Second, we recommend a five year *pilot program* be designed and conducted in which Contracting Officers may elect to use the number of employees to determine small business status. This pilot should aim to provide an even playing field by building upon the concepts already in place. NAICS codes for Engineering, Logistics, SETA and telecommunications size standards designated small businesses by number of employees, ranging from 500-1500. It would be beneficial and helpful to establish a tier size according to the number of employees for small businesses. We propose the following tiered system:

Number of Employees	Tier
1-150	Tier 1
151-250	Tier 2
250-500	Tier 3
500-1000	Tier 4
1000-1500	Tier 5
1500-2000	Tier 6

The pilot program should be designed to ensure businesses performing under current socio-economic programs are not disadvantaged by the Tier system. Using a pilot program provides

the flexibility to make interim adjustments in response to changes in the business environment and to leverage lessons learned.

At least one federal agency has recognized the value of the Developing Second-Tier Business. They have small businesses that have been providing goods and services to their agency for a period of years. During that time, the small businesses have proven their capabilities and developed invaluable knowledge of the agencies' environment. When the small business contracts end and they have exceeded the NAICS small business standards, the proven small business contractors are no longer eligible to bid and must subcontract to less experienced small businesses. The second-tier firm has done everything they have been asked to do and often more than. Now they are penalized for their successful performance and support to the customer. The result is that the Developing Second-Tier Business loses at least 50% of its revenue and a large portion of its employees. The agency loses a valuable asset in the prior contractor, and the Developing Second Tier Business may no longer have sufficient revenue to sustain its infrastructure. This loss of infrastructure support can lead to business failure. This scenario occurs on a regular and continuous basis across the federal government.

Our third recommendation is to have different size standards developed for businesses operating in the public and private sectors. Of note, the Standard Industrial Classification (SIC) System (predecessor of NAICS) defined different size standards for performance in the private sector versus the public sector. This was changed to reduce the government's administrative burden of maintaining two classifications. The unintended consequences fell on the government contracting sector, which is dramatically different from the private sector. In a recent meeting with SBA, it was agreed that conceptually, the tiered size-standards approach would be a good step towards helping small businesses transition to full and open competition.

While discussing the tiered approach to small business definition, several challenges were identified. One challenge would be to ensure that procuring agencies give the first priority to small businesses in the 1st tier before inviting those in the 2nd or higher tier and that they do not bundle the contracts to favor higher tiered small businesses at the expense of those at the lower tiers. The DSTSBA agrees that small business concerns should be protected from unfair competition. Under this recommended approach the SBA will coordinate with the designated

federal department(s) who will perform the pilot. The department would be directed to consider other small business programs [8(a), HUBZone, SDVOSB, and traditional SB] *before* considering the enhanced small business set-aside, thus "protecting" smaller 1st tier firms and paving the way for this program to work on appropriate "medium size" contracts. Also, all 1st tier small businesses may "bid up" for 2nd tier set asides but 2nd tier businesses may not "bid down" for 1st tier set-asides.

Subcontracting

The dominance of large corporations is so overwhelming because they continue to absorb the minority businesses' share of the market place, which they achieve not only through outcompeting the smaller businesses but also by acquiring them. These corporations fail to be consistently responsible in fulfilling the spirit and the letter of the Federal Government's subcontracting laws, which are spelled out in public law 95-507, section 211.

To provide an example: a small company by the name of TYBRIN won a small business set-aside contract at Edwards Air Force Base in the Spring of 2009 worth \$342M for a 12-year term. Before the end of the same year, TYBRIN was acquired by JACOBS, a large corporation, who now benefits from this small business set-aside contract for the remainder of its 11 year term. To the Air Force's credit, they are requiring TYBRIN to add a required Small Business subcontracting plan to the Edwards contract, are adjusting the current Award Fee plan to reflect the small business commitment, and fully expect to re-compete this effort at the 5-year point versus the current 11-year term. Additionally, the Air Force annually monitors a contractor's progress towards its small business commitment and reflects that progress in its annual Contractor Performance Assessment Reports. It seems that JACOBS as a good corporate citizen would not need the federal government to force it to comply with the spirit and the letter of public law 95-507, section 211.

In this particular situation, General Wendy Masiello's leadership was the driving force in creating an environment to assure that the minority and small-business community's interests are being served. However, this is not the rule: many major corporations own contracts which were

originally awarded under the small business set-aside program and agencies which awarded these contracts have not taken action to assure that the subcontracting provision of public law 95-597, section 211 is properly enforced.

Other examples: The L-3 Corporation acquired a USCG Training contract and Northrop Grumman acquired an IT support contract at the LA Air Force base. Neither company has any meaningful subcontracting plan to small business on either of these sizeable contracts.

We, as the minority and small business community, do support the federal government's subcontracting reform efforts by the House Bills that are now being considered:

HR 4134 - Subcontracting Fairness Act – Rep. Lacy Clay and Rep. Yvette Clarke – Amends Federal Property and Administrative Service Act of 1949 to require that a prime contractors pre-award subcontract agreement, used for the purpose of bidding successfully of a federal contract will become a valid contract when the award is made.

H.R. 4496 - Helping Small Business Compete Act – Rep Graves – contains provisions that Subcontracting plans subject to a good faith review under regulations to be promulgated, penalties will be applied to an errant prime contractor.

H.R. 4929 - Expanding Opportunities for Main Street Act. Rep. Bobby Rush – Agency can withhold 5% of contract if contractor does not live up to subcontracting goals. Non use of a subcontractor included in the contracting plan must be justified. Agencies must have a phone line for Subcontractor complaints.

H.R. 5019 - SB Bill of Rights - Rep Kirk – SBA must issue regulation requiring a good faith effort to follow subcontracting plan. Fines and other penalties shall be specified.

In-sourcing – A Rising Challenge

Several objectives have been associated with the government's ongoing efforts to convert contractor positions to government employee positions and to restrict the use of contractors for specific government support functions in the future. The identification of functions that are "inherently governmental" is one of the most often cited objectives and is defined in general terms as "an effort to reverse a previous policy of indiscriminately out-sourcing functions that are so intimately related to the public interest as to mandate performance by Government employees."ⁱⁱⁱ While the DSTSBA agrees that there are critical functions that can and should only be performed by government employees, we believe that the underlying principle associated with those functions is the authority to make decisions. We are convinced that "inherently governmental" should be defined in terms of acceptance of the responsibility and exercise of the authority entrusted to government employees to do the "people's work" in the most efficient and effective manner. This definition is consistent with the definition of inherently governmental established in 1992:

These functions include those activities that require either the exercise of discretion in applying Government authority or the making of value judgments in making decisions for the Government. Governmental functions normally fall into two categories: (1) the act of governing, i.e., the discretionary exercise of Government authority, and (2) monetary transactions and entitlements. (Policy letter 92-1: Subject: Inherently governmental functions, 1992)

"Inherently governmental" should not be defined by process but rather in terms of decision making and execution authority. To suggest that government officials can be inappropriately influenced by the data and information provided by contractors in the decision making process demeans the intellectual capacity of government decision makers and questions the integrity of a dedicated and experienced contractor work force. After all the arguments are put forward, when "inherently governmental" is reduced to a discussion of who provides the information needed to make informed decisions it takes on the appearance of protectionism for the unions and limits the government's access to talent, an unequalled employee experience base, and innovation. DSTSBA has two recommendations to address this issue: 1) recommends policies related to "inherently governmental" be based on the Policy Letter 92-1 definition given above; and 2)

require a “small business impact study” prior to any in-sourcing decision to determine the impact on existing small business contractors.

Large Businesses become Small through Acquisition

What has been described as “unfair competition” refers to the inadvertent entry of other than small businesses into the small business competitive area. In most instances, entry is achieved as a result of the acquisition of a small business. To correct this situation, some Contracting Offices now require annual - recertification. In some, perhaps isolated instances, recertification has resulted in the loss of work by small businesses that, as a result of innovation and initiative, have outgrown their small business status. This situation does not occur in the solicitation process, but after the contract is awarded. Therefore, the DSTSBA recommends **annual recertification**. We recommend that a small business should retain its small business status during the entire period of performance for any small business contract that is in effect. If the small business outgrows its small business status, the business must compete in the unrestricted category for all new work. Again, the change in **small vs. unrestricted** status may be as a result of growth or acquisition.

Infrastructure Capacity Affected by “Graduation”

Businesses need strong and stable infrastructure to grow. Infrastructure includes accounting systems, human resources systems, intellectual capital (especially in the executive levels) technology systems, strategic planning processes, and other industry specific standard business processes. The key word is stable, because as business size fluctuates, so does its infrastructure, and like a physical building, as the infrastructure weakens, so does the entire business, which may lead to an early death.

A study of the annual receipts of small firms shows there is a significant decline in businesses across all industries when the annual receipts go from \$1- 5M to \$5 – 10M. For example, in 2002, the Information Industry (NAICS 51) shows that in the first category (\$1 – 5M) there were 13,263 firms, but in the second category (\$5 – M), the number of firms declined to 2,572, which

represents an 80% drop.^{iv} The Professional, scientific and technical services industry (NAICS 54) shows an 88% drop in firms.

Note: These figures are for ALL firms in an industry. Small government contractors represent a subset of these firms.

Source: U.S. SBA, Office of Advocacy, based on data provided by the U.S. Census Bureau.

We understand that this decline could be due to a number of things including the usual spasms associated with business growth and development, and that the Census data is for all businesses and not just federal government contractors. But, the drop is so significant as to lead one to believe there may be a relationship between the most common small business NAICS with a revenue ceiling of \$7M and this drop in revenue. This data lends support to our contention that just as a firm reaches a level of stabilization in its revenues and infrastructure; it is no longer eligible for the support provided to other small businesses.

We recommend that this Subcommittee direct development of a study to determine the impact of graduation from current small business categories on small business infrastructure and revenues.

Summary and Conclusion

The federal government's small and minority business development programs and the esteemed members of the Subcommittee on Management, Organization, and Procurement, Committee on Oversight and Government Reform do an excellent job of supporting and overseeing the establishment and growth of small businesses. We believe that it is fair to say, however, that the record of viable small businesses after 8(a) and other small business program graduation is not nearly as good.

The federal government has invested millions in dollars in support of small business development. Therefore, it behooves the government to protect its investment by ensuring that businesses that have grown to the maturity phase are allowed to continue to grow and mature. We contend that the federal government has single-mindedly focused on the start-up and growth

phases of business development while ignoring the maturity phase. We also suggest that in this time of economic challenges, the government cannot afford to let any business decline which will ultimately lead to more unemployment.

Our testimony focuses on 1) Restrictive Size Standards; 2) In-sourcing, a rising challenge; 3) Large businesses become small through acquisition; and 4) Infrastructure capacity. Of these challenges, we have emphasized Restrictive Size Standards because it is the main roadblock for the Developing Second Tier Firm and it is the main goal of the Mid-Tier Advocacy group.

We recommend the following:

- Suspension of the current revenue standards for small business determination in favor of using only an employee size standard.
- A five year *pilot program* be designed and conducted in which Contracting Officers are encouraged to elect to use the number of employees to determine small business status. “Enhanced Small Business Opportunities”
- Develop different size standards for businesses operating in the public and private sectors.
- Policies related to “inherently governmental” be based on the Policy Letter 92-1 definition given above.
- Annual recertification of small businesses.
- Development of a study to determine the impact of graduation from current small business categories on small business infrastructure and revenues.
- Require a “small business impact study” prior to any in-sourcing decision to determine the impact on existing small business contractors.

Madam Chairman , and members of the committee we strongly urge this committee and the special task force that President Obama has formed to implement policy based on the recommendations that have been collectively developed and presented in this testimony today. We sincerely appreciate the opportunity to provide testimony before the Subcommittee today. We are prepared to answer questions and welcome your suggestions on any further actions that could result in policy changes to support small and matured small businesses.

End Notes

ⁱU.S. Census Bureau, North American Industry Classification System. <http://www.census.gov/eos/www/naics/>

ⁱⁱ SBA, Summary of Size Standards.
<http://www.sba.gov/contractingopportunities/officials/size/summaryofssi/index.html>

ⁱⁱⁱ Policy letter 92-1: Subject: Inherently governmental functions, 1992.

^{iv}U.S. Small Business Administration. Employer Firms, Establishments, Employment, Annual Payroll, and Receipts y Receipts Size of Firm and Major Industry using NAICS, 2002. http://www.sba.gov/advo/research/us_rec_mi.pdf