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Letter from Washington

For the last several months the talk in Washington has been about the inevitability of "sequestration", and the negative effect that will have on the defense industry. Given the impact of sequestration, a short primer on appropriations terminology is probably in order.

In a very simplified look at a very complex subject, each year prior to the expiration of the fiscal year on September 30th, the Congress is supposed to pass twelve individual appropriations bills that fund operations of the US government for the coming fiscal year. There are a dozen appropriations bills but obviously more than a dozen government agencies, so most of the bills provide funds to more than one department. In the case of defense, because of the size and complexity of the enterprise, military construction is split out from the main defense bill and is appropriated separately. In the case of smaller agencies, several are lumped in together (Interior, Environment and Related Agencies, for example).

Once the Congress appropriates the money and the various appropriations bills are signed by the President and become law, the assumption is that the funds allocated by the House and Senate will be transferred to the appropriate agency and obligated and executed as authorized.

Again, in a very simplified version of the world, there are three things that can happen to the appropriated funds that will keep them from being spent as originally intended:

- **Reprogramming.** As the name implies, appropriated monies are reprogrammed for another purpose within a department. Generally the departments of the executive branch have a limited reprogramming authority provided by Congress that allows the agency to operate efficiently and respond to contingencies. The reprogramming authority within a line item is generally modest, and in the case of DoD is usually held to the low tens of millions, with the most flexibility in the personnel accounts. If the department seeks larger reprogramming, permission must be received from the Congress before dollars can be shifted around. Toward the end of the fiscal year the agency comptrollers will want to shift money from programs that are not performing well to those that are so that the funds remain

within the department. This is a Congressional prerogative that is guarded closely.

- Rescission. Again, as the name implies, the Congress can rescind funds that have been appropriated but not yet spent. This can happen in the case of programs that are canceled and the agency is not allowed to reprogram the money elsewhere. When money is rescinded, it functionally ceases to exist and is returned to the US treasury.
- Sequestration. Finally we get to the point of the discussion and the issue at hand. Funds can be sequestered as the result of Congressional language in the spending bills that caps expenditures at a certain level, or as the result of other occurrences that would cause the Congress not to spend money as originally planned and appropriated. Sequestered funds are set aside and may not be obligated by the affected agency, although, unlike rescinded money, the sequestered funds continue to exist.

Armed with that knowledge of the arcane Congressional budgeting process, in order to understand the current situation we need to go back to last summer and the Budget Control Act of 2011. When the Republican House faced off with the President last summer over raising the debt ceiling, the protracted standoff was resolved with the appointment of a "super committee" that would identify \$1.3T in deficit reduction savings. If the committee could not agree on a plan, the \$1.3T would be assessed across the federal budget, with Defense absorbing half of that requirement. The across-the-board, indiscriminate approach was supposed to be so unthinkable that the committee would be forced to act in a bipartisan manner to find a solution. Obviously that was a forlorn hope, and the committee failed to agree, which started the clock ticking for the January 2, 2013 sequestration of the \$1.3T.

For more than six months the Congress has been faced with the prospect of the sequestration of funds and the massive hit to the defense budget that would ensue. Remember that defense has already absorbed a \$500B reduction, so the addition of the sequestered funding would equate to more than a \$1T reduction over 10 years. For the most part, all agree that the additional defense reductions would be harmful to national security and should be stopped, but there is no agreement on how to do it. Republicans are still firm that whatever grand bargain is struck should not include any tax increase, and the Democrats are holding the line on any restructuring of the big entitlement programs without increased revenue (i.e., taxes).

To say that neither side has an incentive to do anything before the Presidential election in November understates the case. Both sides are positively disincentivized to give anything at all before the election, until it becomes clear who the winners and losers are. As a result, the Republicans

and Democrats in the Congress are circling each other like the two proverbial scorpions in the bottle, waiting for an opening to inflict damage.

So where does this leave the prospects for a defense bill for 2013? Just like there is no incentive for compromise before November on sequestration, there is no incentive to work together and produce the twelve appropriations bills required to fund the US government by October 1. As a result, we almost certainly will have another Continuing Resolution that will fund the agencies of government until the new Congress is seated in January. As we have previously discussed in these letters, a prolonged Continuing Resolution is harmful because it provides a period of uncertainty when government managers really don't know what funding levels they will have to work with.

In 2013 there are four possible end games that can play out in January:

- Obama wins
 - sequestration is allowed to take place
 - sequestration is prevented
- Romney wins
 - sequestration is allowed to take place
 - sequestration is prevented

In three out of four of these scenarios, the defense appropriation will be substantially lower. In the fourth, it will probably be lower but is too hard to predict now.

The immediate effect will be that going into the fourth quarter of FY 2012, the government is likely to curtail contracting sharply. Even routine non-competitive contract renewals will be held in abeyance until program managers understand what they have to work with, and that will not be clear until January.

Defense companies need to prepare for the worst case, which would be sequestration plus reduced defense spending for further deficit reduction. As a result, going into the last quarter of 2012 the larger companies have stopped hiring and have started to make plans for the large-scale layoffs that will be necessary with sequestration. Some CEOs have been quite vocal in publicly scolding the Congress for creating this situation and then failing to resolve it a timely manner, which has done nothing to move things before the election.

For its part the DoD has made the situation worse by refusing to plan for sequestration, and continuing to operate on the basis that there will be a Congressional fix --- clearly not going to happen. Secretary Panetta's strategy is apparently to prevent any formal planning from leaking and then becoming enshrined as the established way forward. As a result, there has been no planning for how the DoD will react to sequestration, which is even more unnerving to industry.

If the DoD has to face sequestration and another \$500B+ comes out of defense, it will be made even more severe by the Continuing Resolution and lack of a 2013 appropriation. If the sequestration order does come in January, the DoD will have nine months to absorb the reductions rather than the full twelve, and since the CR baseline will likely be higher than the 2013 appropriation when it finally comes, the effect will be a double whammy for the department.

At the same time that defense lobbyists have fanned out across Washington to make the case that sequestration will be devastating to defense, other lobbyists representing the other half of the \$1.3T in reductions have been making the case that it will not. Since the other half of the sequestered funds will come from the rest of the discretionary budget, lobbyists for everything from medical research to the environment have been looking to protect their clients' interests. Interestingly, they point to the fact that DoD absorbed the first \$500B in reductions starting in 2012 without a lot of complaint, and use that as evidence that there is still bloat and waste that can be wrung out of defense without damaging the national interest.

There is also the belief on the part of some Democrats that sequestration might actually be a good thing. They reason that even though their favored programs will also be decimated, they will never be in a position to move so much money out of defense again. In this analysis, the House Republicans outsmarted themselves into believing that the doomsday scenario that they enacted in the Budget Control Act of 2011 was equally frightening to the Democrats.

The last quarter of FY 2012/first quarter of FY2013 will be a time of further confusion and uncertainty, and many government program managers will likely just hunker down and wait for things to become clear, not commit funds and not enter into even short term obligations.