The Federal Construction Sector:
Understanding a Transforming Market

Based upon federal budget constraints, shifting national security priorities and a diverse set of owners with multiple objectives, the federal construction market is transforming rapidly. Given these changes, it is increasingly important for companies working in this space to comprehend the key forces accelerating these changes, as well as the shifts that are impacting the design and construction industry as a whole. Keeping an eye on movements and events – both within the federal construction sector and beyond its boundaries – will lessen the surprise factor and help companies prepare themselves for the next challenge.

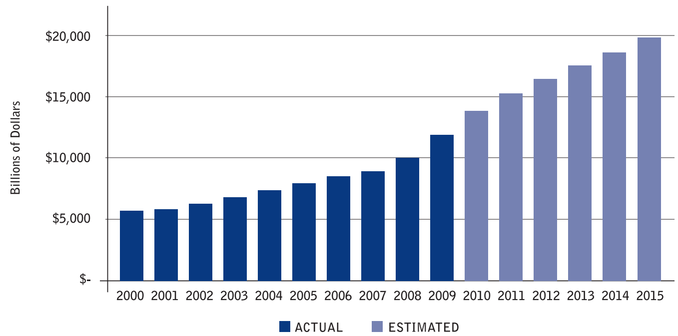
This paper highlights some of the key trends that are shaping the federal design and construction industry in the coming years. The main trends include 1) a decrease in overall funding levels driven by budget constraints and large federal debts; 2) a continued emphasis upon sustainability and energy efficiency in order to achieve larger policy goals; and 3) the lasting reality of federal small business initiatives.

Government Construction Facing a Downturn

When the American Recovery and Reinvestment Act (ARRA) of 2009 was passed into law, the landmark bill was intended to lessen the impact of the national economic recession. Workers would find jobs, the country's infrastructure would be stabilized, and there would be a resurgence in both private investment and consumer spending. Those aspirations fell short. And while ARRA funding did help individual states, and the country as a whole, avert even deeper crises (roads and bridges were repaired, schools continued to be built and staffed, etc.), private sector investment in new capital construction projects didn't flow back into the market as quickly as hoped.

With one crisis averted and the national economy slowly recovering, the U.S. is now facing a mounting national debt and a declining federal discretionary budget (see Figure 1).

Figure 1. Gross Federal Debt



Source: www.usgovernmentspending.com

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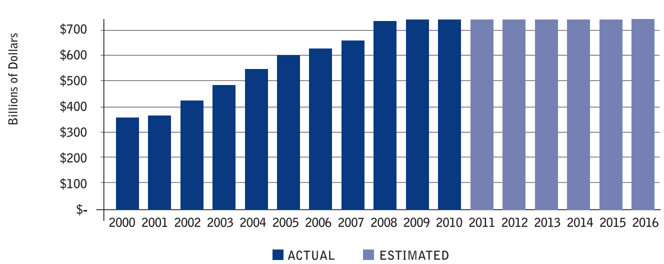
Concurrently, the U.S. construction market is dealing with weak levels of private investment and proposed federal government cuts. The double whammy is alarming for government-focused contractors, and it is also impacting firms that – in light of the sparse private sector project funding – require federal spending for new project opportunities. Companies that assumed increased public spending would tide everyone over until the private market recovered are now wondering where their next project opportunities will come from.

Not surprisingly, numerous contractors, ranging from small to large, have recently attempted to grab a foothold in the fiercely competitive federal market. Consequently, given the complex and bureaucratic nature of the federal construction market, we expect to see less committed and financially unstable firms pull out in the coming years. Growth through federal construction opportunities begins with a well-thought-out plan and a focus on the different government agencies and departments. Working for the federal government should not be viewed as a short-term solution to shrinking private sector opportunities, but as a long-term strategy for growth and diversification. Those companies dedicated to a serious, long-term strategy will likely survive and thrive in the new federal business environment.

Department of Defense: Looming Budget Cuts Ahead

Budget cuts are on the Department of Defense's ("DoD") agenda. In January, Defense Secretary Leon Pannetta announced that the department would request $525 billion for its base 2013 budget (compared to $531 billion in 2012). Panetta said the DoD would also request $88.4 billion for overseas contingency operations (compared to $115 billion in 2012) to maintain support for troops in combat. These budget cuts reflect the DoD's new strategic direction and the department's compliance with the 2011 Budget Control Act, which requires the department to reduce spending by about $259 billion by 2016, for a total of $487 billion in reductions by 2021.

Figure 2. Projected Total Spending for the Department of Defense



Source: www.usgovernmentspending.com

The cuts don't stop there. The Department of Veterans Affairs (VA) and the General Services Administration (GSA) are also bracing for significant construction program decreases. Having just completed its largest expansion since World War II, the VA is decreasing its construction budget by 45 percent (see Table 1). The GSA expects a similar decline and predicts that fewer construction projects will come online this year, compared to recent activity levels. A 2011 spending bill enacted in April reduced the GSA's construction account for 2012 by 94 percent to $50 million. The House panel chopped the agency's $869 million request for repairs and renovations by 61 to $280 million.

Table 1. House Appropriations

Program ($ millions)	FY 2012 House	FY 2011 Enacted	% Change
DOD base realignment and closure	482	2,482	-81
DOD family housing construction	373	357	+4
DOD other military construction	11,489	11,933	-4
VA major construction	590	1,076	-45
DOE defense environmental cleanup	4,938C	4,980	-1
Corps civil works (regular appropriations)	4,768C*	4,857	-2
Bureau of Reclamation water/related resources	822C	912	-10
Total	23,462	26,597	-12

Note: Amounts are rounded, *Excludes $1,029 million in emergency funding for 2011 storm and flood damage repair, C: Approved by committee, no floor vote as of 6/20/2011

Source: House Appropriations Committee

At the same time, the BRAC program for base realignment and closure, which started in 2005, is winding down. During the past six years, the U.S. Army Corps of Engineers (USACE) has executed $16 billion of Military Construction (MILCON) for 275 Army, 127 Air Force and 32 DoD BRAC projects and is on track to meet all of its BRAC program milestones on time. As the program nears completion, the DoD fiscal year 2012 budget for base realignment and closure will be reduced by more than 80 percent over 2011 levels. Steve Bowers, chief, Contract Administration Branch at U.S. Army Corps of Engineers, adds, "In the future, we are going to see more small-scale projects – $100 million or less – including retrofit and O&M-type projects. The mega projects throughout the East Coast and the North Atlantic Division will be rare. There could also be more construction management (CM)-type opportunities since agencies won't have the necessary resources to oversee large construction projects due to recent budget cuts."

Other military DoD construction, which makes up the bulk of the department's construction program, would be reduced by 4 percent this year. Family housing is the one bright spot for the DoD. Spending in that sector is projected to increase by 4 percent in 2012 (see Table 1) as troops return home from Afghanistan and need housing.

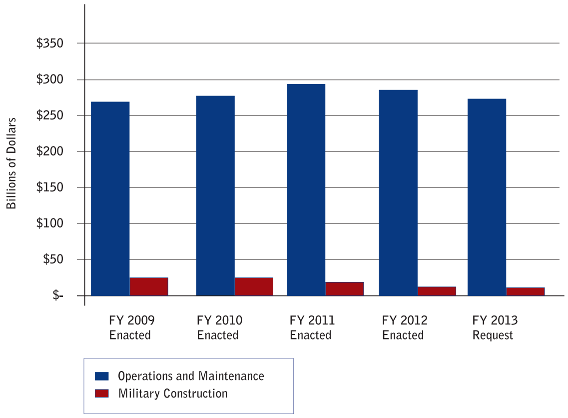
However, President Barack Obama's fiscal year 2013 budget proposes two new rounds of BRAC, one in 2013 and another one in 2015. As it has in the past, a new round of base realignments and closures could generate new work for engineering and construction firms. Shutting down facilities, modernizing bases and handling environmental assessments are just a few of the opportunity areas. Should another round of BRAC be implemented, however, the amount of work generated will depend on where the bases are located, says one industry source. If the bases are small, or if they are based overseas, then the opportunity window will be much smaller than it was during previous BRAC events.

A spokesperson from the Society of American Military Engineers adds that if the size of the Army and Marine Corps. is reduced, then the existing facilities – many of which were built within the last five years – will be readjusted in lieu of building new structures. The focus will be sustaining, renovating and modernizing existing facilities rather than replacing aging structures (see Figures 3 and 4). Many industry experts agree with this view since many of the buildings built during the BRAC boom lack standard energy systems. "I think there's going to be a major push for rehabilitation of existing facilities," says one executive of a large international construction company.

"In the future, we are going to see more small-scale projects — $100 million or less — including retrofit and O&M-type projects. The mega projects throughout the East Coast and the North Atlantic Division will be rare. There could also be more construction management (CM)–type opportunities since agencies won't have the necessary resources to oversee large construction projects due to recent budget cuts."

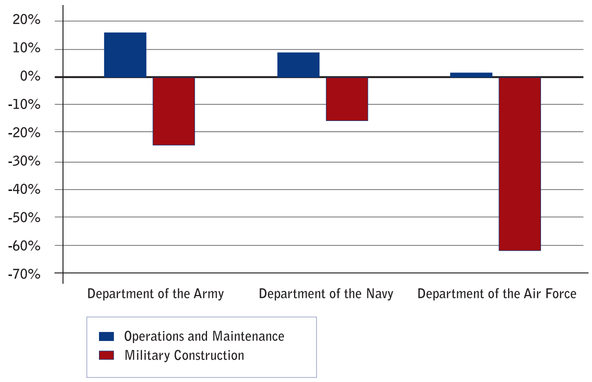
Steve Bowers, Chief, Contract Administration Branch, U.S. Army Corps of Engineers

Figure 3. Total DoD Budget by Appropriation (Shift Toward O&M)



Source: www.comptroller.defense.gov. Overview — FY2012 Defense Budget

Figure 4. Change in O&M and Military Construction Spending, 2011 – 2013



Source: www.comptroller.defense.gov. Overview — FY2012 Defense Budget

DoD's "Strategic Pause"

On January 5, 2012, President Obama announced a new defense strategic guidance entitled "Sustaining U.S. Global Leadership: Priorities for 21st Century Defense." This new guidance is critical since it is intended to reshape future DoD priorities, activities and budget requests for the next decade. The guidance represents a framework for DoD decision makers as they face spending cuts of about $487 billion over the next 10 years to meet the initial budget caps set in the Budget Control Act (BCA) of 2011. The guidance does not account for the possibility of sequestration – further significant cuts that could be required pursuant to implementation of the BCA.

Given the potential scale of DoD budget cuts, security experts are currently debating the role of the U.S. in international affairs and how the U.S. military should be structured to best support this role. As programs in Afghanistan and Iraq wind down, there is a renewed focus on the Asia-Pacific region (mostly air and naval forces), while forces in the Middle East transition to a peacetime ground force presence. Obama's new budget strategy calls for a shift in priorities, with some areas – such as special military operations – receiving more resources and others receiving less. According to Defense Secretary Leon Panetta, "We are at a turning point."

How all these changes will affect DoD construction programs in the future is still unclear. Some speculate on possible scope changes related to multibillion-dollar build-up facilities such as the one on the Pacific island of Guam. Others think that the DoD's plan to bolster its special forces could mean more work to develop infrastructure, such as new training facilities, to support those forces. Essentially, it remains to be seen how all of this will unfold.

The 2012 appropriations debate is far from over. So far, Senate lawmakers have taken no action on any of the 2012 spending measures. What is well-established is the increasing pressure to shrink the federal budget deficit. The ARRA funding spigot, which in 2009 and 2010 helped prevent construction put in place from falling more than 10 to 15 percent, has dried up. Changes in the federal construction sector present great challenge and opportunity for those firms, which can harness the trends in driving the market.

Implications for the design and construction industry:

- The pool of firms competing for federal construction will decrease. Likely survivors will be mature, federal sector-oriented companies.
- Focus on "sustainment," renovation and modernization of existing facilities rather than replacing aging facilities. Extensive O&M spend contrasted with declining new milcon construction expenditures.
- New DoD strategy calls for a shift in defense priorities. Certain areas — such as special military operations ("black" or "secret" sites, cyber-warfare operations, data centers, etc.) — could receive more resources while others may receive less.
- Fewer larger projects and more small-scale ($100 million or less) retrofit and O&M-type projects.
- Construction firms with CM- and O&M-type capabilities will gain a competitive edge.

Drive for Net Zero: Federal Push for Clean Energy Innovation

The federal government operates about 500,000 buildings (3.34 billion square feet) and consumes more than one quadrillion BTUs of energy per year. In fiscal year 2010, it spent $21 billion for all energy use and is the single-largest energy user in the United States (1 percent of the nation's energy consumption).

Based on legislation enacted in 1992 and executive orders issued in subsequent years, the federal government has required all of its agencies to reduce facility energy consumption with the goal of having "Net Zero" buildings in place by the year 2030. The vision of a Net Zero energy building involves collecting as much energy from renewable sources as the structure uses on an annual basis while maintaining an acceptable level of service and functionality. Buildings can exchange energy with the power grid as long as the annual net energy balance is zero.

Today, many federal agencies have attained approximately 30 percent of this Net Zero energy use goal, primarily through innovative, sustainable design and construction practices developed during the past decade (e.g., LEED), building retrofits and various alternative energy implementations. The Army, for example, has numerous pilot installations under way to test renewable energy sources, such as solar photovoltaic panels, as well as new techniques to reduce waste and conserve water. According to Kristine M. Kingery, director of Army sustainability policy, a part of the Office of the Deputy Assistant Secretary of the Army for Energy and Sustainability, "The pilot installations involved now in the Army's Net Zero Installation Strategy are test cases to see what's possible. They are striving toward goals for 2020. By 2014, an additional 25 installations will come on board in the program, and those installations will have a target year of 2030. The Army's overall goal is to reach net zero status in all three areas (energy, water and waste), for all installations, by 2050."[1] Furthermore, in a new solar power study commissioned by the Defense Department's Office of Installations and the Environment, researchers estimated that there is enough vacant land on seven military bases – stretching from California to Nevada – to generate 7,000 megawatts of solar energy. That is the equivalent of seven nuclear power plants. According to the study, the federal government could generate up to $100 million a year (through additional revenues and/or reductions in energy costs) by leasing that vacant land out to solar developers.

The idea of trading land in exchange for renewable energy led to the launch of a task force of energy and acquisition experts. The task force's main goal is to attract $7.1 billion in private investment over the next decade – the estimated amount of private capital that the Army needs to be able to derive 25 percent of its energy from renewable sources by 2020. Katherine Hammack, assistant secretary of the Army for installations, energy and the environment, explains, "We have land we need to keep in the Army inventory for multiple reasons ... That land is one of the things we can offer a private developer. In exchange, we will be a purchaser of their energy."

That scenario would find private companies building solar farms, wind turbines or other renewable energy projects on Army property. The Army would either accept the electricity as an in-kind payment for the land usage or become a guaranteed customer for the electricity generated. Hammack adds, "In many cases, the Army expects the solar, wind and geothermal facilities to end up producing more energy than the base hosting them actually needs. The developers will then have the opportunity to make money from selling energy back to the grid."

Red tape could stand in the way of that plan though. The solar power study states that solar development on military bases is governed by a "complex web of laws, regulations and market rules, administered by public and quasi-public entities" at nearly every level of government. Written before solar energy made an impact on the renewable-energy market, the laws will push DoD staff and their partner companies to tread carefully before proceeding with development.

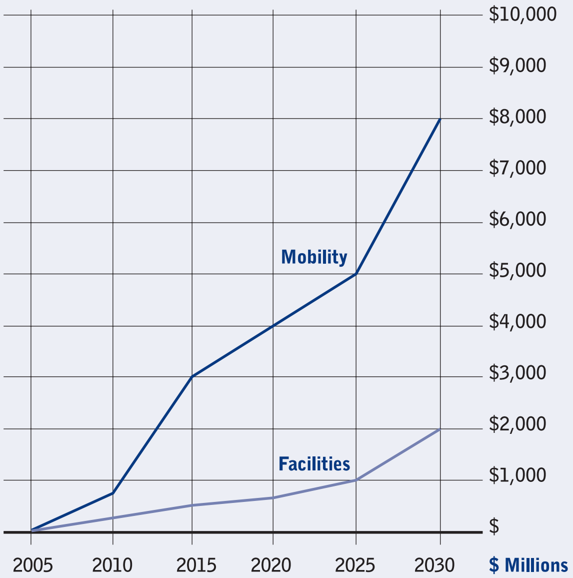
1 Installations making progress toward 'Net Zero' by 2020. C. Todd Lopez. U.S. Army News. January 20, 2012.

U.S. Military to Invest $10 Billion Annually in Renewable Energy by 2030

According to a recent report from Pike Research, the DoD's annual spending on renewable energy will reach $10 billion by 2030. Some of this will be spent on facilities operations, including permanent bases, but the majority of the spending will be allocated to mobility applications. Those applications include portable soldier power as well as land, air and sea vehicles. "The DoD is positioned to become the single most important driver of the cleantech revolution in the United States," says Pike Research president Clint Wheelock.

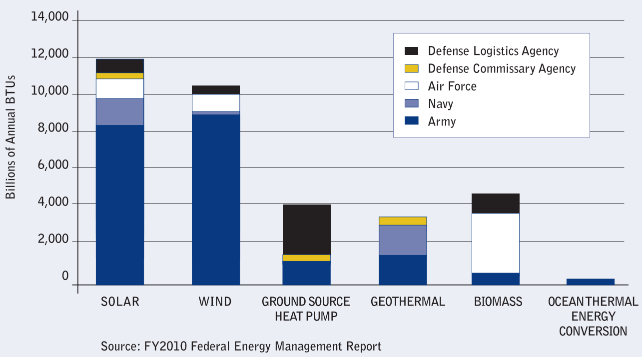
DoD's energy expenditures include 75 percent for fuel and 25 percent for facilities and infrastructure. Key sectors that will receive significant Pentagon attention and investment over the next two decades include solar power (for both permanent bases and temporary facilities); microgrids for military facilities; fuel cells for individual soldier power; and biofuels for military vehicles (particularly the Navy's "Great Green Fleet" initiative, which will shift to a largely biofuels-driven fleet by 2016.) The total market for renewable energy for mobile power is forecast to reach $6.1 billion by 2030.

Figure 5. DoD's Investments in Clean Energy



Source: Pike Research

Figure 6. DoD Estimate of Renewable Energy Production Potential



Source: FY2010 Federal Energy Management Report

As part of their efforts to achieve Net Zero, federal agencies have also begun to adopt life-cycle cost analyses in order to evaluate new building opportunities. This "total cost of ownership" analysis will not only measure the upfront expense of a facility, but also take into account the cost of maintaining and operating a facility over its expected lifecycle. Such analysis presents additional opportunities for engineers and construction firms responding to government solicitations. While initial construction outlays will be important, a more expensive but more efficient building (when incorporating ongoing ownership costs) may be deemed superior. Further, creative design and engineering concepts that incorporate operational cost savings will likely be recognized and adopted.

Perhaps most importantly, all firms aiming to contract with the federal government need to understand and master the life-cycle cost analysis framework in vogue with the specific federal agency. As with any federal government procurement, both form and function will be important. Utilizing life-cycle cost analysis and being conversant with an agency's methodology for calculating such benefits will be a competitive advantage in the proposal process.

Retrofit as a Platform for Innovation

The General Services Administration ("GSA") is also leading the way in sustainable design and construction practices, with numerous initiatives under way to modernize existing buildings, construct new ones and establish new industry standards in collaboration with the private sector. One such initiative is the Green Proving Ground program (part of a larger smart building strategy), which utilizes the GSA's real estate portfolio to test and evaluate the effectiveness of technologies and practices in a building operations environment. Larry Melton, assistant commissioner, Facilities Management & Services Programs at GSA, states, "We try to test 12 to 15 new technologies each year. Findings are then shared and discussed among industry authorities; if appropriate, we deploy the new technologies at a broader scale. These efforts also support our ongoing development of environmental performance specifications for federal buildings."

The GSA's Net Zero Renovation Challenge, which aims to improve the energy performance of federal buildings through the use of energy service performance contracts (ESPCs), is

"Last year, GSA received a record $1.7 billion in reimbursable funding for small projects. This is money that we receive from tenant agencies to perform the work. Given current budget trends, we anticipate more small projects, which are needed to keep our buildings operational and perform critical building repairs. This is good news for small businesses as GSA awards represent a very large percentage of this work to them."

Larry Melton,
Assistant Commissioner,
Facilities Management &
Services Programs, GSA

another innovation platform that's under way. Energy services companies that already provide ESPCs to federal agencies will retrofit approximately 30 federal buildings nationwide as part of the challenge. The projects will be evaluated by a panel of independent experts based on energy savings, technical innovation, cost savings and the applicability to other federal buildings. The winning entries will be awarded the ESPCs as well as future ESPCs.

Melton emphasizes how other programs, such as GSA's advanced metering program, have improved significantly over the past three years and are now more than just aspirations. He adds, "We have installed well over 1,000 advanced meters in our buildings nationwide (gas, electric or water) and continue to push this program in the future." As smart building technologies continue to improve and as costs come down, investments in such projects will become more feasible and prevailing among tenants.

However, the engineering and construction industry does face some challenges in the near term to assist federal agencies in accomplishing their smart buildings goals. As an early adopter, the federal government believes that today's construction labor force is still relatively slow to catch on to technological advancements that are transforming the way buildings are being designed, built/modernized and operated. "The human aspect is the biggest challenge we face," explains Melton. "Many mechanical, electrical or even general contractors are not used to working in this kind of technological environment. It will take time to adjust and adapt to these changes."

Steve Bowers, chief, Contract Administration Branch at the U.S. Army Corps of Engineers, confirms this concern: "One of the challenges I foresee is the limited amount of skilled workforce to perform some of the more complex projects, particularly in the secured areas. In addition, design and construction firms will need to make sure they have sufficient U.S. citizen staff that passes all government clearances. That is something the industry needs to take into consideration."

Beyond Construction: The Big O&M Opportunity

Federal building owners and facility managers face the ongoing challenge of improving and standardizing the quality of information that they have at their disposal, both to meet day-to-day operational needs as well as to plan for life-cycle costs, future upgrades and maintenance activities. Several industry stakeholders interviewed in this study confirmed that sustainable design and construction practices are creating novel opportunities for construction firms in the O&M space. Melton adds, "Right now, there is a unique opportunity for the construction industry to partner with the O&M industry for the sole purpose of ongoing commissioning. Construction companies that have strong partnerships with O&M contractors are the ones being most successful in this (smart facilities) market."

Building information modeling (BIM) technologies play a key role in this discussion. BIM provides information to facility managers about building systems, including architectural, structural, plumbing, mechanical and electrical. While BIM has proven its value in design and construction for more than five years, BIM facility management technologies are still evolving. Despite the high number of new facilities and buildings that have been designed and built with BIM software over the last 10 years, the opportunities to improve facility management practice and leverage this store of information are plentiful.

Many federal agencies, including the U.S. Army Corps of Engineers (USACE), have made long-term system-wide commitments to BIM and associated technologies like the Construction Operations Building Information Exchange (COBIE). COBIE allows the USACE to capture BIM facility data and enable project stakeholders to enter the data (as it is generated) during design, construction, commissioning and use. This eliminates the need to create data at the end of a project in the form of post-construction or as-built hard copies. Today, USACE requires several types of projects to provide this kind of facility data as a project deliverable. Manufacturers, suppliers and contractors will have to embrace these technologies and collaborate in innovative ways.

Implications for the design and construction industry:

- Net Zero policy goals will continue to drive adoption of energy-efficient buildings and acquisitions of alternative energy solutions.
- Federal agencies offer fertile ground for innovative development and private investment opportunities, given the aggressive goals related to Net Zero compliance still to be achieved.
- Federal agencies are looking for construction companies that are knowledgeable of sustainable design and construction practices, comfortable using emerging technologies and open to new ways of building, financing, operating and maintaining structures.
- Facility management will be paramount and a well-trained, technologically skilled field labor force will be a benefit to construction firms attempting to meet the federal government's energy retrofit objectives.
- Construction companies that develop strong partnerships with O&M contractors or that develop O&M in-house capabilities will gain a competitive edge.
- Strong consideration will be given to TCO/Life-Cycle Cost Analysis. Construction providers must learn how to build proposals that accommodate, and that are sensitive to, these concerns.
- Companies pursuing renewable energy markets such as solar power that master and learn to work within the patchwork of applicable laws, regulations and market rules governed by public entities will form a competitive advantage.

Increasing Opportunities for Small Businesses

The federal government awarded a record $97.95 billion in federal contracts to small businesses in fiscal year 2010 (Oct. 1, 2009 – Sept. 30, 2010) – or 22.7 percent of eligible contracting dollars. It was the largest, single-year award amount in five years and a significant improvement over FY 2009, when small businesses received 21.9 percent of contracting dollars (see Figure 7).

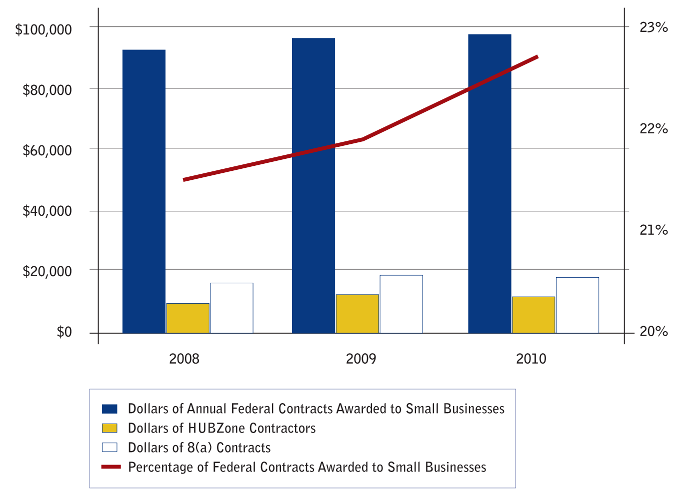
Over the past year, the Small Business Administration ("SBA") has stepped up its federal agency collaboration efforts and created more opportunities for small businesses to compete for

"In my 30 years of contract experience with the federal government, I have never witnessed such an emphasis and focus on promoting small business. We are seeing policies and guidance issued by the Office of Management and Budget, the Office of Federal Procurement Policies, the Deputy Assistant Secretary of Defense for Acquisitions, Logistics and Technology – support at the highest levels of the government."

Jackie Robinson-Burnette, Associate Director of the Office of Small Business, U.S. Army Corps of Engineers

and win federal contracts. Final results for FY 2011 will not be available until the third or fourth quarter of 2012, but preliminary data indicates that the SBA will achieve its internal target for contracting – awarding 67.5 percent of all its contracts in FY 2011 to small businesses.

Figure 7. SBA Contracting Numbers for Fiscal Years 2008 - 2010 (Dollars in Millions)



Source: U.S. Small Business Administration, Agency Financial Report, Fiscal year 2011

Federal departments and agencies are required to expend 23 percent of their annual procurement dollars on small business awards. Unfortunately, many agencies have fallen short of these targets and without penalty. To stoke agency participation and follow-through, Rep. Bill Owens (D.-N.Y.) introduced a bill in January entitled, "The Small Business Growth and Federal Accountability Act" (H.R. 3779). The Act is designed to "hold accountable federal departments and agencies that fail to meet goals relating to the participation of small business concerns."

If enacted, the bill – which is now being reviewed by the House Small Business Committee – would slash a federal department's or agency's budget by 10 percent for not hitting its established small business procurement goals. The question becomes: How will federal agencies react to this penalty?

Other Key Developments for Small Businesses

SBA raises "small" business thresholds for engineering and architectural firms. Until recently, engineering or architectural firms with average gross revenues up to $4.5 million (over three years) were considered "small" as defined by the SBA's stringent federal procurement regulations. This changed in February when the SBA increased the size standard for architectural services to $7 million and $14 million for engineering services. The rule is effective March 2012. Consequently, architectural and engineering firms that did not meet these thresholds in previous years can now regain small business status provided they fall within the newly defined revenue thresholds.

New bills aim to funnel more contracts to small businesses. Along with "The Small Business Growth and Federal Accountability Act," the U.S. House of Representatives' Small Business Committee chair recently introduced a pair of bills: Government Efficiency Through

(GET) Small Business Contracting Act and the Small Business Advocate Act, which would raise governmental small business contracting targets and intensify advocacy for small companies. These are the first of several bills that the Small Business Committee plans to unveil this session in an effort to reform small business contracting.

As a result of the GET Small Business Contracting Act, the government's business contracting target would increase from the current 23 to 25 percent. This lower goal is one that the government missed in both 2010 and 2011. The 2 percent increase would funnel $11 billion in new business to small companies every year, according to the representative who introduced both bills, Sam Graves, R-Mo. Additionally, the bill would give 40 percent of all contracting dollars to small firms – an increase from the current 34.9 percent. Graves stated that if "federal agencies do not meet those goals, then senior agency officials' bonuses would be withheld."

The Small Business Advocate Act would also address contract insourcing and bundling, and would facilitate the Federal Office of Small and Disadvantaged Business Utilization's activities around helping small companies in acquisitions.

Federal agencies have also instituted a significant push toward policing small business compliance. This intent was confirmed in an interview with Ms. Jackie Robinson-Burnette, associate director of the Office of Small Business, U.S. Army Corps of Engineers: "We expect to see a renewed focus and commitment to compliance and accountability in the area of small business subcontracting…No longer will a large business be able to win a large prime contract (which has a subcontracting goal to give a portion of the work to small businesses) and miss those goals without some type of consequence."[2]

Increase in Service-Disabled Veteran-Owned Small Business (SDVOSB) opportunities. With the wars in Iraq and Afghanistan concluded, all federal agencies are helping to put thousands of men and women who once wore their country's uniform back to work. This effort is part of the larger "Veteran Job Corps" initiative that the president unveiled in February. Burnette adds, "I think the SDVOSB program is going to grow the largest over the next few years. It is a newer program and one that we focus on more closely here at the Corps. We are committed to the soldiers and officers who risked their lives for our country and want to make sure that there is a place for them upon their return."

Setting up a SDVOSB concern can be challenging, though, and requires thoughtful planning and extensive background research. According to Dean Nordlinger, counsel with PilieroMazza, a general business law firm with a specialized practice in government contracting, "In order to succeed, a SDVOSB must walk a fine line between complying with applicable regulatory requirements and dealing with business realities. Nowhere is this tension more apparent than with respect to an SDVOSB's ownership structure. Ideally, an SDVOSB's governing documents will strike the proper balance between the applicable SBA and/or U.S. Department of Veterans Affairs (VA) regulatory requirements and the pursuit of its business objectives. However, careful planning is necessary to make sure the right balance is struck."

2 In January 2012, legislation was proposed calling for a $500,000 penalty for large businesses failing to subcontract in accordance with their contract goals.

This detailed level of preparation and planning is even more critical considering the SBA's current scrutiny of SDVOSBs, which resulted from recent allegations of fraud and abuse in the SDVOSB program. To qualify as an eligible SDVOSB, a business must satisfy the following criteria:

- It must be considered small under the applicable NAICS code assigned to the government procurement.
- It must be at least 51 percent owned by one or more service-disabled veterans.
- The management and day-to-day business operations of the concern must be controlled by one or more service-disabled veterans.[3]

HUBZone small business concerns may lose program eligibility. When 2010 Census data regarding unemployment rates and income levels was released on October 1, 2011, nonmetropolitan counties and census tracts that the program 're-designated' in the program no longer qualified as HUBZones. That means small firms with headquarters in those expired areas are no longer able to maintain their HUBZone certifications. Roughly 3,400 firms will be decertified, according to SBA estimates.

Those small companies remaining in the HUBZone program should check their status to ascertain whether or not they meet the 35 percent employee residency requirement. Any firms that do not meet this or any other HUBZone certification requirement are being encouraged to voluntarily remove themselves from the program. If warranted, those firms can re-apply for certification after a 90-day waiting period.[4]

Key Challenges to Overcome

While the social and policy objectives of these small business programs are honorable, they present challenges in practice for the firms charged with implementing them. Certain of these issues were raised during a hearing before the U.S. House of Representatives Armed Services Committee Panel on Business Challenges within the Defense Industry in January. Lynn Schubert of the Surety & Fidelity Association of America presented the following findings:[5]

- ***Contract size.*** Very often government contracts are unnecessarily bundled into one large contract and bid. Consequently, small contractors do not have the capability to perform the work on these large jobs nor can they secure the necessary surety bonds. This will likely change in the future as confirmed by Burnette, who says, "I see a huge focus on avoidance of bundling contracts. Consequently, there will be more smaller projects for small construction companies to compete on." Furthermore, industry representatives are advocating the development of more clearly defined procurement policies that provide small construction firms with access to projects that they can perform.

3 For more information, check out: https://www.sdvosb-council.org/

4 For more information, check out: http://imedia.sba.gov/vd/media1/training/HUBZoneBriefing/index.htm

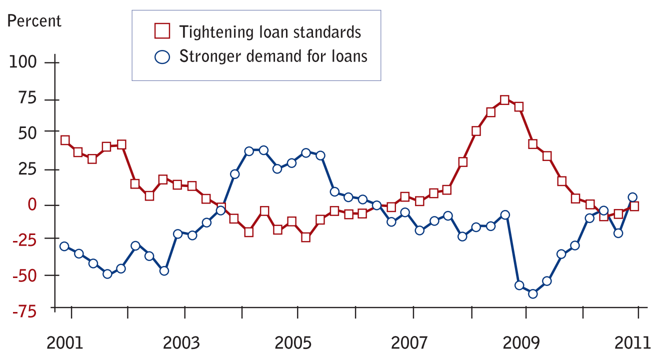
5 The Surety & Fidelity Association of America. Testimony of Lynn Schubert. Before the U.S. House of Representatives Armed Services Committee Panel on Business Challenges within the Defense Industry. "Doing Business with the DOD: Unique Challenges Faced by Small and Midsize Businesses." January 17, 2012.

- ***Bonding versus capital.*** Frequently, small and emerging contractors that encounter difficulty in obtaining bonding actually may have capital problems instead. In today's tight credit market, for example, they may not receive the bank lines of credit they need for long-term business stability. To get bonds, small contractors primarily need capital, capacity and experience. According to Schubert, "A capital access program combined with a surety bond access program would be the best solution for some contractors."

- ***More clarity around joint venture and mentor-protégé programs.*** Mentor-protégé programs and joint ventures are a great way for small construction firms to team up with and learn from larger firms in order to win and perform federal contracts. In some cases, however, policies and regulations around these programs lack clarity and standardization among the procuring agencies as to what arrangements are acceptable. Occasionally, the regulations may present disincentives for smaller contractors to participate in such ventures. Schubert explains, "A small business may lose its 'small' status if it participates in a joint venture in which the partner does not qualify as a small business or, in some cases (such as the 8(a) mentor-protégé joint venture), the protégé does not control the joint venture. Once an otherwise-qualified small business loses its status for that particular set-aside opportunity, the small contractor cannot take advantage of the set-aside opportunity and the federal agency letting the construction contract faces an obstacle in meeting its small business participation goal."

Some or all of the existing small business legislation that is currently being discussed will clearly impact the design and construction industry further down the road.

Figure 8. Small Business Bank Lending



Note: Change in percentage of respondents from the previous period.
Source: Office of Advocacy, U.S. Small business Administration from data provided by the Federal Reserve Board Senior Loan Officer Survey.

Implications for the design and construction industry:

- The current administration is heavily focused on promoting small business opportunities. This trend will likely continue in the coming years.
- The new regulations and policies regarding "unbundling" of contracts will create more opportunities for small construction firms.
- Construction firms will have to dedicate more resources to contract administration and educate themselves more seriously about evolving contract requirements due to growing pressure to comply and adhere to government regulations.
- Large construction firms should partner with small business entities that are – and will continue to be – awarded a significant portion of agencies' total project expenditures. Companies involved in joint ventures or mentor-protégé programs need to be well-informed and up-to-date on agency-specific regulations and policies regarding these programs.

Conclusion

The federal construction market is a complex mix of submarkets that are influenced by a broad range of constituencies and shaped by key forces like looming budgetary constraints, fierce competition, and stringent policies and regulations. More than ever, design and construction firms must gain deep understanding of the specific forces shaping their space within the larger federal "ecosystem" – one of the most complex and dynamic business environments in the world. Firms that anticipate and adapt to these changing circumstances will not only survive the current federal construction market transformations, but will thrive on those shifts.

Entering the federal construction market is not an easy feat. Success in the market requires a long-term commitment, a sharp focus and a well-thought-out plan. Once a firm has established its presence and reputation, the opportunities remain abundant, particularly in the realm of renewable/clean energy, smart buildings and small business initiatives.

Now is the time for design and construction companies to shape their own destinies by becoming experts in sustainable design and construction practices; to partner with the O&M industry (or add those capabilities in-house); to develop technically proficient workforces that think in terms of "systems" not "processes"; and to bring innovative financing solutions to the table. Additionally, by partnering with non-traditional industry stakeholders, industry leaders will further differentiate themselves from their competitors.

Short of devolving into commoditized, low-bid operations, the smart federal firm will carve out a long-term "space" by providing services that target its audience with acuity. The quickening pace of change will ensure that new leaders emerge from the field, and that former mainstays disappear. Tomorrow's federal design/construction leaders will anticipate and adapt to this all-encompassing change. To get there, firms will have to ask themselves, "What makes us unique?" and then move beyond the value-cost tradeoff to create and fulfill new demand. ■

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