

Inflation and Your Supply Chain

Written by Nick Sanders

Monday, 22 January 2024 19:34

I'm getting too old for this stuff.

I've seen too much, and now I'm seeing too much stuff repeat. There's no reason this stuff has to repeat except for incompetence. *Not you.* You're good. It's your boss. And their boss. Those folks are clowns and, if they weren't so great at politics, they would be deservedly booted out from Executive Row on their well-padded derrieres.

So ... here we go.

Nearly six months ago I published a blog article about inflation. Here's [a link](#) to it. You remember that time, don't you? Inflation was running at historic highs and everyone was concerned.

First Rant: "Historic highs" if you discount all the other times inflation was at similar—or even higher—rates. But since we have memories that are hazy about last week, it's not really surprising that almost nobody remembers history.

*Hello? **Whip Inflation Now?***

Anybody? Yeah, like that. History is dead. Nobody has any historical context anymore. Trust me, 8.5% inflation isn't too bad in historical terms. In 1917, annual inflation almost hit 18%. In 1946, annual inflation did hit 18%. In the 1970's inflation sucked. So, there is plenty of "lessons learned" related to managing contracts and suppliers in an inflationary environment.

But none of you—and none of your bosses—implemented any of those lessons.

How do I know that? Keep reading.

So, anyway. I published that article. I thought it had some interesting and potentially useful content. I even spoke on the topic to a fairly well-attended Government Contract Pricing conference. Well, the conference was well-attended. My presentation? Not so much. Everybody seemed to be at the other session, where DCAA and DCMA were talking about inflation using government-approved talking points that didn't offer much in the way of new, innovative, thinking. (Okay. Do I sound bitter about that? I'm not. Not really. I mean, I understand the thought. Who is Nick Sanders, anyway? Nobody of any consequence.)

In that now aged and forgotten-in-the-sands-of-time article, I wrote—

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That's a nice legal position, but when your mid-tier and lower-tier suppliers—and your small business suppliers—begin to go bankrupt because the costs of performing the contracts exceed their available cash flow, and your “reprocurement costs” associated with Terminations for Default are meaningless because the suppliers are bankrupt and can't pay—and in many cases there will be no other suppliers to perform in any case—and when your programs start to fall behind schedule and now you have to report Nunn-McCurdy breaches to Congress ... well. At that point you will realize—*far too late*—that your lawyers' advice wasn't so smart after all, because you didn't deliver your weapon systems and your contractor services to your warfighters, even though you adhered to contractual policies and procedures.

Not incidentally, delivering goods, services and weapon systems to the warfighters is, fundamentally, the *entire job* of the Department of Defense's back office.

The memo seemingly ignores history, when inflationary pressures (among other factors) led to the United States Government *bailing-out Lockheed via an Act of Congress*. Don't believe us? Google it. One salient fact was the imminent insolvency of Rolls-Royce, maker of aircraft engines. One report summarized the situation thusly: “If the engine supplier for the L-1011 was bankrupt, the contract for the RB.211-22 engine would be nullified.” Now, perhaps the crisis was driven by technical challenges in fixed-price development contracts, but the salient fact is that the contracts were fixed-price, and the contractors couldn't absorb the associated losses. If the supply chain collapsed, the prime contractor (i.e., Lockheed) was toast.

Now, I'm watching my prediction come true.

People's Exhibit A: “Lockheed, Howmet Price Fight Over F-35 Titanium Goes Public.” ([Source](#)) As Michael Bruno wrote on 04 December 2023 in *Aviation Week Online*

Lockheed's lawsuit—filed in U.S. District Court for Northern Texas—alleges Howmet in November demanded a ‘massive price increase’ on titanium materials used in the Joint Strike Fighter (JSF) and other systems, beyond the numbers specified in their underlying contract. The Fort Worth Star-Telegram reported that when Lockheed and other subcontractors refused to meet Howmet's request, the company stopped supplying.

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There's more.

For its part, Howmet on Dec. 1 said it has complied with its contractual and regulatory obligations to Lockheed. The cornerstone supplier painted a picture of rising prices for materials, in part due to Russia's invasion of Ukraine in February 2022.

'Since 2022, Howmet has been transparent with Lockheed Martin about these challenges and has acted in good faith to attempt to reach a reasonable resolution for the benefit and long-term health of the F-35 Program,' Howmet said in a public statement. 'While such discussions were still ongoing, Lockheed Martin unfortunately chose to file a meritless lawsuit seeking to compel Howmet to continue to supply product at prices that no longer reflect commercial reality and on terms that Howmet believes it is not contractually obligated to provide.'

It's ironic that Lockheed must contend—once again, 50 years later—with a supply chain issue that threatens the single largest defense contract currently being performed. Alanis Morissette should add a new lyric to her song.

Anyway, the latest news on the dispute is that Lockheed Martin attempted to invoke “national security” to force Howmet to provide titanium but the Judge said no to that.

The point I tried to make six months ago is that the subcontract language may be unenforceable—or winning the lawsuit may be a Pyrrhic victory for LockMart. What do I mean? If they force Howmet into bankruptcy then it doesn't matter what the contract says. LockMart just becomes another creditor in the bankruptcy proceeding. Meanwhile: no titanium. No F-35 production. Other companies in the F-35 supply chain—those who rely on the raw titanium to process into bulkheads and suchlike—they have no input and therefore no output. They start to go under, as well. And for LockMart, they don't have any more planes in shape to deliver to their customers. They start to incur liquidated damages or other penalties found in the prime contract. It's not a pretty picture. In other words, LockMart can win and still lose everything.

Second Rant: They did this to themselves, quite frankly. I ain't got no sympathy for them. *You simply cannot expect to enforce a fixed-price subcontract in a highly inflationary environment.*

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Airbus figured that out relatively quickly when its A380 supply chain was threatened. What did Airbus do? Did they drag their suppliers into court?

Nope.

What they did was to renegotiate the contracts so that it was economically feasible for the suppliers to perform. Lockheed Martin could have done that same thing, if they'd looked around for some historical lessons learned and implemented them. Lockheed Martin could have acted like smart business people and negotiated a solution. They might have had to eat some planned profit, but at least they'd keep their program intact. Instead, they listened to their lawyers. I ain't got no sympathy for them.

None.

People's Exhibit B: "Bankrupt Co. Asks Court To Reject Gulfstream Supply Deal" (Source: Alyssa Aquino, Law360)

Incora, a bankrupt aerospace supply chain management company, urged a Texas court to immediately end a Gulfstream supply contract that became unprofitable during the COVID-19 epidemic, contesting Gulfstream's claims that a contract termination clause must be honored for Incora to reject that deal.

To be clear, the supply contract with Gulfstream did not cause Incora to go bankrupt; but it was certainly a factor. Let's dive a bit deeper.

June 9, 2023—about seven months ago—Ben Unglesbee, writing in [SupplyChainDive](#), said—

Incora's bankruptcy sends a warning signal to aerospace supply chains: Over the past year, the dollar value of late shipments from Incora's suppliers has increased by ninefold, with on-time deliveries at around 50%.... Average lead time for shipments of parts has doubled to 18 months from nine months. That caused a major problem for Incora, 'because its role in the aerospace industry (and some of its contracts) require it to maintain substantial inventory that manufacturers and maintenance service providers can call upon at any time,' Carney noted.

Incora has taken on added costs because of shortfalls, in part by buying alternative supply at higher costs to fill gaps, leaning on expedited freight to move goods more quickly, and because

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of labor costs to turn late-arriving inventory faster, according to Carney.

Moreover, the company has had to pay higher prices for inputs as inflation spiked for raw materials, costs that Incora can't pass on to its customers because of the timing of its contracts. Carney also said that 'many suppliers of proprietary parts have exploited their position to raise prices in excess of general inflation rates.' ...

As for Incora, the company is looking to address its debt burden — partly a legacy of its leveraged buyout by Platinum Equity. The company also aims to use the Chapter 11 process to, as Carney put it, bring 'unprofitable customer contracts' in line with 'current economic and commercial reality.'

Tip of the iceberg time, gentle readers. Tip of the iceberg. Two stories about different companies, both facing the economic realities of fixed-pricing contracts in a time of high inflation. Two suppliers with inflexible prime contractors. Two prime contractors with supply chain problems.

I bet you have some of those same challenges. What are you going to do? Are you going to enforce strictly the terms of your subcontracts, even if that means destroying your suppliers? Is that the hill you are going to die on?

Or are you going to negotiate some compromise that preserves your supply chain at the cost of short-term profits?

Well, I bet I already know your answer. Here's what you'll say: "I'll do what my boss tells me to do."

And therein lies the true root cause of the problem.