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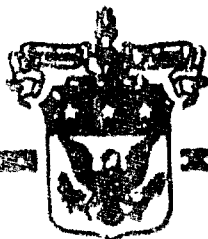
SMALL BUSINESS SET-ASIDES: IS DOD
GETTING ITS MONEY'S WORTH?

BY

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SMALL BUSINESS SET-ASIDES:
IS DOD GETTING ITS MONEY'S WORTH?

AN INDIVIDUAL STUDY PROJECT

by

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ABSTRACT

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Small Business Procurement Assistance Programs had their genesis in World War II. The set-aside program was designated as a major federal procurement practice in promoting small business participation. In Fiscal Year 1987, federal spending for goods and services from the small business sector totaled \$197.3 billion or one-fifth of total federal outlays. However, inequities in the distribution of large federal outlays during the eighties provided the basis for congressional reforms. The Business Development Reform Act of 1988 was aimed at strengthening the set-aside program. This paper examines the major events that influenced the congressional action and proposes several initiatives to enhance a declining defense industrial base through small business participation.

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INTRODUCTION

Small Business Procurement Assistance Programs had their genesis in World War II. In the first two years of World War II, 16 percent of U.S. small businesses closed their doors.¹ They lacked the capital to compete against big business for labor and raw materials without government intervention.

Consequently, in 1953, Congress passed the Small Business Act directed at assisting small business in time of peace as well as war. Subsequent amendments have attempted to ensure that a fair proportion of Federal supply and service contracts are offered to all segments of business, large and small.

The Small Business Act directs that small business set-asides be made to achieve any of the following purposes:

- "(1) ...maintaining or mobilizing the Nation's full productive capacity;
- (2) ...be in the interest of war or national defense programs; (or)
- (3) ...assuring that a fair proportion of the total purchases and contracts for property and services for the Government in each industry are placed with small business concerns."²

When properly implemented, the program creates a "sheltered effect" for smaller firms and encourages participation in the Federal market. The program also prevents larger firms from dominating a market and provides an incentive for small business capital investment.

The set-aside program was designated as a major procurement practice used in promoting small business participation. Under

this program, contracting officers set-aside selective procurements solely for small businesses whenever they expect that at least two responsible firms will offer a product at a reasonable price. Certain classes of procurements such as purchases under \$25,000 and construction contracts under \$2 million are automatically reserved for small business consideration. Contracts can be awarded as either a total or partial set-aside. This set-aside determination is either a unilateral decision by the contracting officer or a joint effort in coordination with a Small Business Procurement Specialist.³

Contracting with minority-owned, small disadvantaged businesses improved with the Small Business Administration's (SBA) 8(a) Program. The major provision of this program, restricting competition to small disadvantaged businesses known as 8(a) firms, is comparable to a small business set-aside. Through a cooperative effort with the procuring activity, SBA identifies from its 8(a) portfolio, those firms capable of producing the required supplies or services. Contracts are then awarded on a noncompetitive basis to SBA, which, in turn, subcontracts with the 8(a) firm.⁴

The 8(a) program fosters business membership by socially and economically disadvantaged individuals while providing an opportunity for full participation in the free enterprise system. The goal is to award at least 5 percent of small business federal procurement dollars to small disadvantaged business.

This small business procurement process, as it has developed over the years, has served the Nation well and should not be

subject to blanket criticism. In Fiscal Year (FY) 1987, for instance, the Federal Government purchased \$35.4 billion or nearly 18 percent of its total goods and services from small business.⁵ Unfortunately, however, the set-aside and 8(a) programs have not been self-executing. Inequities in the distribution of these large federal outlays provided the basis for congressional reforms in 1988.

The Business Opportunity Development Reform Act of 1988 was aimed at strengthening the set-aside and 8(a) programs of the Small Business Act. This paper reviews the major events that influenced the congressional action and proposes several initiatives to enhance a declining defense industrial base through small business participation.

THE DYNAMICS OF SMALL BUSINESS AND GOVERNMENT SPENDING

The congressional interest in the small business economy is best understood by reviewing the dynamics of the small business sector and the purchasing power of the Federal Government. The small business imprint on the Nation is succinctly reflected in President Reagan's 1988 Proclamation for Small Business Week.

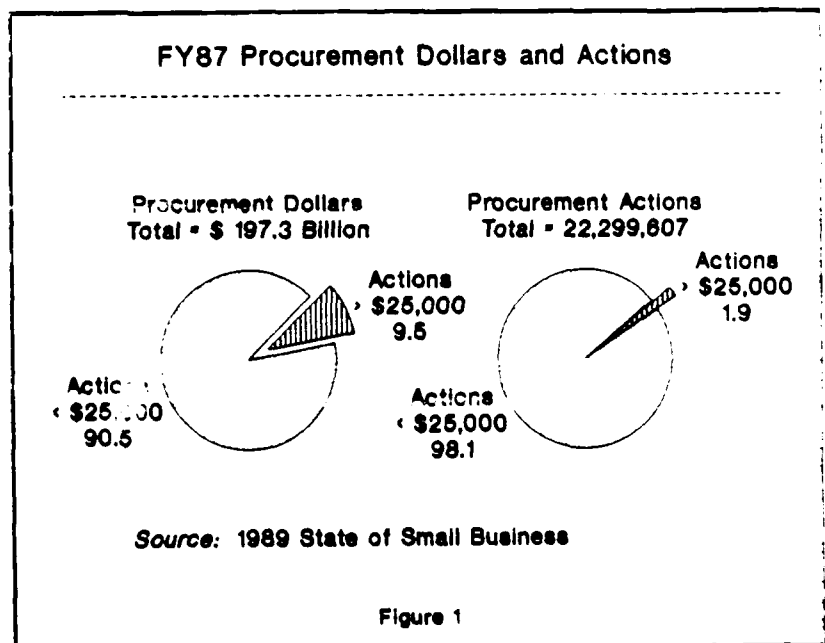
"More than 17 million Americans own a small business; and the rest of us benefit from their ingenuity, enterprise, and hard work. These entrepreneurs employ half of all Americans in the work force...small businesses provide well over two-thirds of all new American jobs, as well as 40 percent of our aggregate national output; the bulk of new American products and technologies; and more than two-thirds of all first jobs...In the next quarter-century, fully three-fourths of all new jobs created in America will have their genesis in small business."⁶

The U.S. Government's purchasing power is equally dynamic. In FY 1987, federal spending for goods and services from the private sector totaled \$197.3 billion or one-fifth of total federal outlays. The small business community received \$35.4 billion, or nearly 18 percent of direct contract purchases. Small business subcontractors received an additional \$25.9 billion from prime government contractors. Thus, in the FY 1987 aggregate, small business provided about 31 percent (\$61.3 billion) of the total goods and services purchased by the Federal Government.⁷

The complexity of the federal procurement process was also increased considerably by the growth in dollars, number of transactions, and regulatory requirements. The challenge of administering small business programs in this environment is put in perspective when analyzing the procurement volume.

Figure 1 illustrates the 22.3 million

procurement transactions processed in FY 1987. Over 98 percent of government contracts was under \$25,000. These smaller actions accounted for 9.5 percent of the dollar volume. Conversely, 90.5 percent of the dollar volume was in the 2 percent of contract



awards over \$25,000.⁸

In terms of shares of total dollar awards, small firms won more smaller awards than larger contracts. Small businesses acquired 46 percent of the dollar volume of contract actions under \$25,000 and 15 percent of the contract actions over \$25,000.⁹ Simply stated, small firms in FY 87 were doing big business with the U.S. Government. This trend has continued.

PROGRAM SHORTFALLS

Set-Aside Trends

Department of Defense (DOD) is the largest source of Federal contracts, accounting for approximately four of every five dollars in purchases over \$25,000. In FY 1987, DOD awarded \$26.6 billion to small firms and an additional \$3.3 billion to small disadvantaged firms.¹⁰

Defense procurement data indicate that the military departments are becoming increasingly reliant on set-asides to achieve their small business goals.

Figure 2 depicts a positive trend, a period of steady growth in both dollars and percent of set-asides to total contract awards.

A cursory review of several industries

	1987	1986	1985	1984	1983	1982
Total DOD Awards	135.3	135.3	139.6	124.9	121.1	102.5
Award to Small Business	26.6	26.9	26.0	23.8	22.8	20.1
Percent to Small Business	19.7	19.7	18.7	19.1	18.8	19.7
Set-aside Dollars	14.5	14.1	14.0	12.4	11.7	10.0
Percent Set-aside to Total Award	10.6	10.3	10.0	9.9	9.7	9.8
Percent Set-aside to Total Small Business Awards	54.5	52.4	53.8	52.1	51.3	49.7

Source: SBA Reauthorization and Amendment Act

Figure 2

highlights the inequitable distribution of set-asides across all markets. For example, SBA estimated that in FY 1986, set-asides totaled \$16.5 billion government-wide. At the same time, construction set-asides represented \$4.5 billion or roughly 27 percent of the entire set-aside program.¹¹

Figure 3 illustrates a sampling of market imbalances in set-aside contracts for that fiscal year. These statistics indicate that small business dominates service industries in a wide range of activities. Three

DOD FY86 Set-aside Sampling (in thousands of dollars)			
Description	Total Market	% Small Business	% of Market Set-aside
Custodial janitorial	230,123	99	43
Food Service	273,370	96	37
Maintenance repair	2,614,613	85	74
Communications equip	8,884,683	7	2
Aircraft components	1,330,279	5	1
Vehicle components	393,895	8	5
RDT&E	16,907,714	7	2

Source: Legislative History, House Report No. 100-694
Figure 3

of these industries, custodial janitorial, food service, and maintenance repair, received 43, 37, and 74 percent respectively, in contract set-asides.¹²

During this same period, small manufacturing firms for communications equipment, aircraft components, and vehicle components received less than ten percent of the procurement dollars in their industries. Additionally, small firms acquired only seven percent of the research, development, test, and evaluation dollars. The market share of set-asides in these industries varied between one and eight percent.¹³

Historically, markets with an abundance of small businesses

have received a disproportionate share of set-aside contracts. Additionally, the DOD set-aside program has been heavily oriented in service and construction markets. It was not the intent of Congress that set-asides be used almost exclusively in a few markets, while other segments received little or no emphasis. Nevertheless, this can often be the result. SBA's 1989 Region VIII profile of 130 small disadvantaged program participants, for instance, accentuates the dominance of a construction (46%) and service-oriented (44.5%) small business economy, while manufacturing accounted for only 8.5 percent. This six state regional trend increases the risk of losing critical small business defense manufacturers.¹⁴

IG and Audit Findings

1. DOD Inspector General's survey found the Defense Department in compliance with set-aside procurement regulations. The survey reviewed six buying activities that awarded 20 small companies \$1.2 billion in 43 set-aside contracts. Regrettably, the scope of the survey did not include an analysis in the distribution of set-asides. Nevertheless, the survey reflected that contractors were generally manufacturing the items offered and that subcontracting work was minimal except in the clothing and textile industry.¹⁵

In contrast, an Army audit of ten set-aside contracts for road resurfacing, found that large firms had been subcontracted to perform either all or most of the work. These contracts, totaling approximately \$2 million, were awarded over a three year period to the same small firm. The firm then subcontracted most

of the work to a larger firm specializing in asphalt paving. A similar finding was reported for a set-aside contract to install a telecommunications system. In effect, the smaller firms functioned as little more than brokers. The audit concluded:

"Although noted at only two installations... the problem...may be widespread, as the cause appeared to be systemic. The guidance...is somewhat fragmented and subject to interpretation...Considering the magnitude of the small business set-aside program...more definitive guidance is warranted."¹⁶

In a move to rectify such small business market imbalances, the Business Opportunity Development Act introduced two pilot programs. One program targeted five industry categories dominated by small business to determine how well they would perform in unrestricted competition. The law established an annual set-aside participation goal of 40 percent in each designated industry group. The second program directed federal agencies to identify ten industries with low small business participation to determine if targeted goaling could expand contracting opportunities for qualified small firms.¹⁷

Congressional Interest in the 8(a) Program

The 8(a) program was first used by President Lyndon Johnson as part of his Great Society.¹⁸ For that administration, the program was the primary vehicle to guide federal procurement decisions concerning minority-owned businesses. In this regard, the program served two critical and complementary purposes: first, it provided an element of fairness to taxpayer-financed contract distribution; second, it created opportunities for minority-owned businesses to compete successfully in a free

enterprise economy.

Unfortunately, two significant events in the intervening years undermined confidence in the 8(a) program and threatened erosion of public commitment. The first focused on the failure to achieve the statutory goal of long-term business development without a dependency on Government contracts. A 1986 survey solicited input from 461 firms that had graduated from the program during the preceding four-year period. The success rate for program graduates continuing to operate as private entities ranged from 70 to 79 percent. Respondents found the program was most helpful in awarding government contracts, but was least helpful in providing management, technical, or financial assistance. Thus, the program was viewed as a contracts assistance program in lieu of a business development vehicle.¹⁹

The second event centered on the scandal surrounding the Wedtech Corporation, a beneficiary of two major 8(a) contracts awarded in 1982 and 1984. In April 1988, the Oversight Committee of Government Management issued a report tracing the involvement of four federal agencies - the White House, the Army, the Navy, and the Small Business Administration - in determining Wedtech's eligibility and awarding of the 8(a) contracts. The Subcommittee found an "unfortunate picture of favoritism, political influence, mismanagement, and improper and irregular decision-making."²⁰

A General Accounting Office (GAO) report echoed the findings of the subcommittee, emphasizing that the program had done "too much" for "too few" for "too long" while finding little progress in the program's effectiveness in assisting firms to become self-

sufficient businesses. The report, in part, concluded that:

"...a large percentage of 8(a) contracts continue to be awarded to a very few firms... In 1987, the top 50 firms received \$1.1 billion, or about 35 percent of the total value of 8(a) contracts awarded that year. In contrast, 1,225 of the 2,938 active 8(a) firms ...did not receive any 8(a) contracts in fiscal year 1987, and another 555 firms did \$100,000 or less in 8(a) business."²¹

The congressional consensus was that both programs were not only necessary; but were a potentially effective catalyst in apportioning taxpayer funds to small businesses. The set-aside imbalances and Wedtech scandal provided the momentum to promote legislative reforms in two key areas - eligibility and business development.

Missed Contracting Opportunities

The lack of a small business institutional strategy exacerbates the erosion of the defense industrial base. A decade of procurement decisions promoting construction and service businesses has contributed to the decline of domestic manufacturing firms vital to national defense programs.

In July 1989, the Legislation and National Security Subcommittee reported that America once the leader in the consumer electronics industry, had not placed a single firm among the world's top 20 electronics makers for that year. Additionally, the subcommittee pointed out that America's export share of machine tools, first invented in this country, had crumbled from 23 percent of the world market to 4.7 percent in less than three decades. Representative John Conyers Jr., (D-Mich), described the impact of this increased foreign defense

subcontracting in his opening statement to the subcommittee:

"Notwithstanding a two trillion dollar defense buildup in the decade of the 1980's, it appears that the condition of the defense industrial base is weaker now than when the spending spree began. A report by the Georgetown Center for Strategic and International Studies suggests that over 70,000 fewer U.S. firms are suppliers to the Department of Defense in 1987 than were in 1982. DOD foreign subcontracting that can be reported, increased from \$715 million in fiscal year 1984 to \$1.7 billion in fiscal year 1987. Imports continue to displace U.S. firms at the supplier tier, where over half of procurement dollars go...which existing technologies and which promising technologies should we support to reclaim our industrial base and enhance our national economic destiny?"²²

WHAT NEEDS TO BE DONE

Senior civilian and military leaders need to convey a strategic vision that stimulates the competitiveness, commitment, and confidence in the small business industrial base. This vision should promote an institutional strategy that is creditable and consistent with the objectives of the Small Business Act; a strategy that targets small business producers in declining defense industries; a strategy that builds a small business infrastructure that can compete in a global economy; and a strategy that provides access to technology, skilled and adaptable labor, and an equitable distribution of investment capital.

The greatest challenge for the defense leadership will be in promoting small manufacturers within the procurement bureaucracy. The traditional view is that large firms bring efficiency at the price of a certain rigidity, and small firms bring flexibility at

the price of instability. The cultural mind-set views small manufacturing firms as low-tech, high-risk and unresponsive.

The Bureaucratic nay sayers need to be reminded of the innovative potential of small businesses reflected in their contributions to developing over half of the major technological advances this century. The jet engine, helicopter, gyrocompass, automatic transmission, vacuum tube, frequency modulation radio, and tungsten carbide are but a few examples of these achievements.²³ Moreover, many manufacturing firms such as Apple Computer started out as a small business.

Assess Industries Vulnerabilities to the year 2000

The Bureau of Labor Statistics explored the economic impact of reduced military spending over the next decade. They reported that in 1988, 2.9 percent of total private wage and salary employment was related to defense expenditures. This estimate included both direct expenditures, such as purchases of aircraft or supplies, and indirect expenditures, such as employment generated by purchases from defense suppliers. By the year 2000, total defense-related employment was projected to decline by one-third, or to 1.7 percent of total private wage and salary employment. Nearly 60 percent of this decline was projected in manufacturing industries.²⁴

The Bureau also projected a drop of almost 20 percent in total defense-related employment within a 4 percent annual reduction in defense outlays from 1989 to 2000. Their analysis examined detailed industry and occupational employment projections under this funding projection.²⁵

Those industries most heavily dependent upon direct defense spending and their projected job losses are reflected in figure 4.²⁶ Bureau statistics also demonstrated that occupations with the largest decrease in

Industry	1988*	Projected 2000*	Absolute Difference
1. Guided missiles and space vehicles	135.0	102.6	-32.4
2. Ordnance	51.8	34.6	-17.6
3. Aircraft and missile engines and equipment	211.5	121.6	-89.9
4. Ship and boatbuilding	100.9	71.3	-29.5
5. Aircraft	179.3	113.1	-66.2

* Jobs in thousands
 Source: Bureau of Labor Statistics Economic Projections

Figure 4

defense-related employment were in the electronics field. They included 69 percent in electrical and electronic assemblers of precision and conventional equipment and 54 percent in electronic semiconductor processors.²⁷

Because military spending inherently affects certain industries, the list of job losers presents no real surprises. The effects of reduced spending tends to be relatively minor at the aggregate level. However, the loss is significant in industries and occupations most closely tied to the Department of Defense.

The risk of losing additional small defense manufacturers will only increase with a declining budget. Roughly 355,000 U.S. small business manufacturers are responsible for approximately 46% of the value added in domestic manufactured products.²⁸ These firms make up the "base" of the manufacturing economy.

To an important extent, the competitiveness of major U.S. manufacturing corporations depends on the small business suppliers.

Strategic Importance

It is in our national interest to target set-aside and 8(a) manufacturing goals toward vulnerable defense industries. This point became clear in May 1988 when a Nevada plant was destroyed in an industrial accident. The plant produces almost half of the nation's supply of ammonium perchlorate (AP). Without it, the space shuttle can't lift off, and many commercial space launch vehicles can't fly. On the military side, AP is essential to the propulsion systems for conventional weapons like the multiple-launch-rocket system (MLRS), the Patriot surface-to-air missile, and strategic nuclear weapons.²⁹

It took 18 months for a new AP plant to be built and become qualified. During that period, supplies of AP were restricted to the highest priority needs. Lower priority, but still critical requirements for AP, such as the MLRS program, were stretched out to accommodate a 40 percent reduction in AP deliveries.³⁰

Barely six months later, the country's only manufacturer of aerospace-grade rayon, which is used in protecting lining for nosecones and nozzles, announced that its plant was closing. Ironically, the same systems (i.e., the space shuttle, military rocket and missiles, and commercial space-launched sector) were affected. To maintain rayon deliveries for the shuttle and military systems, DOD and NASA temporarily "rescued" the manufacturer.³¹

These are but two examples of the national security risk in defense industries with limited depth or single-source suppliers. A smaller defense budget will only increase the number of single source domestic defense suppliers. The defense leadership needs to convey a strategic vision that assesses and reduces these vulnerabilities through small business participation.

Industrial Policy

Achieving full compliance with public law and regulatory requirements dictates an aggressive campaign that reflects creditable and consistent top-down direction. Consistency is particularly important. In this regard a former Under Secretary of Defense for Acquisition, attributed the decline of defense business to the degree of difficulty and lack of profitability in supporting government programs.

"...if we're smart, we'll establish the rules of engagement such that people are encouraged to be good suppliers...As we build down, we have to look at what happens to the defense industrial base. Do you decide to use taxpayer money to subsidize so you have the ability as a nation to mobilize...At that point, its no longer a business decision, but rather a policy decision on how much insurance you want to pay for. And yes, it may come to that point."³²

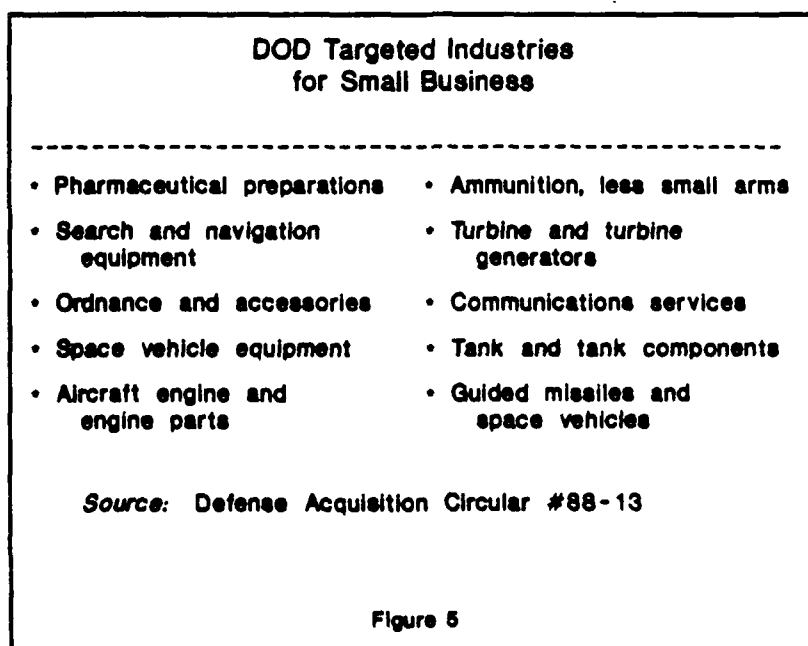
The philosophy of government subsidies needs to be thoroughly examined and an industrial policy written that targets vital domestic manufacturers for the next generation of defense weapon systems. Our business-as-usual approach of awarding contracts to a lowest bidder creates an erratic and unpredictable long-term business plan. Small firms in high-risk defense industries need an industrial policy that assures a reasonable

commitment in proven performance. Acknowledging this, the head of the Office of Science and Technology Policy, stated in regard to the success of America's high-tech weaponry in the Persian Gulf, that "competitiveness and national security aren't separated anymore, ...The two are intertwined and have to be treated that way."³³

Targeting Small Manufacturers

A critical area in need of attracting a larger segment of small business participation involves major system acquisitions. Prime contractors need an incentive to develop subcontracting plans that specifically call out qualified small and small disadvantaged businesses. An effective means of institutionalizing small business participation is by designating the Subcontracting Plan as a primary evaluation tool in the source selection process. This will guarantee early involvement of a teaming effort in the research, development and production phases of major weapon systems.

One major improvement is the Business Opportunity Development Reform Act which bonds small business competitiveness with national security. The law directs federal agencies to target ten industries



with limited small business involvement. DOD has identified the industries for the program (see figure 5).³⁴

Although this approach is not a cure-all, it provides an incentive for small manufacturing firms to compete in emerging technologies that are risky, very expensive and involve smaller production lots. Moreover, the Government's commitment to expand small business participation in major defense programs provides an additional inducement for long-term investment. Most importantly, the new act aligns small business programs with the national security objectives of the 1953 Act.

Reducing the Administrative Burden

Government should eliminate or reduce onerous regulations that inhibit small business growth and in some cases threaten their very survival. The administrative burdens that accompany regulatory oversight are a major drain on small business resources. Small firms operate with limited capital, often at the margin. Many rely on short-term borrowing to finance their operation. Unlike large corporations, they cannot afford batteries of lawyers, accountants and clerks to process the myriad forms and to decipher masses of rulings associated with government contracts.

SBA needs to take on the task of analyzing the cost and relevance of regulations to small businesses. The problem is that oversight requirements are developed to regulate large companies without understanding the economic impact on small firms. Government regulations are essential for maintaining an orderly society; however, a proper balance is needed to ensure

oversight of taxpayer funds while eliminating inappropriate requirements that overburden small firms.

Industrial Organization

Industrial Organization, not size, is the major dilemma for small business. Today's unit of production is no longer from the individual company but from a decentralized network of companies. These networks consist of vertical linkages tying small suppliers to large final assemblers. In other cases, the linkage is horizontal, binding together a number of more or less equally small companies. In both cases, these networks generate continual innovation through a delicate balance of competition and cooperation, demand and support.

It is this type of cooperative venture that SBA and DOD need to pursue in promoting set-aside goals in vulnerable defense industries. Cooperative ventures can cover various institutional and legal arrangements including industry-university, industry-laboratory, multi-firm, and industry-university-Government. Proponents of cooperative ventures argue that they accomplish work in areas too expensive for one company to support while allowing ongoing R&D efforts that cross traditional boundaries of knowledge and experience.

An excellent example of the federal government's responding to a declining industry is Sematech - a research consortium of 14 American electronics firms that have banded together in an attempt to regain their place at the top of international companies producing computer chips. Sematech centers on a five-year, \$1.2 billion effort to develop tools and manufacturing

techniques in order to help produce computer chips, or semiconductors, faster and more efficiently.³⁵

This program breaks down some of the principal barriers, such as access to scientific and engineering knowledge and capital, that discourage small firms from competing in science-based industries. The success of Sematech will play a major role in developing a computer chip technological base that will enhance defense as well as commercial programs.

Conference on Small Business

In early 1994, the President will sponsor a National White House Conference on Small Business. This conference will be preceded by similar gatherings in individual states beginning in December 1992. The Small Business Administration and Defense Department need to utilize these state conferences as a catalyst in identifying impediments to government contracting and promoting their commitment to expanding the role of small business manufacturers.³⁶

CONCLUSION

It is unlikely that the industrial base will again mobilize to the extent required during World War II. Notwithstanding this fact, small business is vital to sustaining a strong peacetime defense industrial base. Maintaining a strong domestic production capability enhances our deterrence strategy. With few exceptions, the small manufacturing sector in the United States lags behind that of other major industrial nations. In the interest of national security, it is essential that the defense leadership optimize the nation's investment in the small business

manufacturing economy.

President Harry S. Truman voiced his concern for the future of small business in a letter to the Administrator for the Small Defense Plants Administration. "We have got to keep small business in this country as strong and healthy as we can," he wrote in January 1952. "That is essential to our national welfare and the economic progress in the future."³⁷

As the Nation builds down to a smaller military force, President Truman's concern for the small business economy is applicable in today's environment of allocating declining resources for tomorrow's defense programs.

ENDNOTES

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3. Federal Acquisition Regulation, Part 19, Subpart F 19.5, pp. 19-10.2 to 19-12.

4. Ibid., Subpart F 19.7, pp. 19-15 to 19-16.

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6. "Proclamation 5766," in United States Code Congressional and Administrative News, 1988, Vol 7, p. A7.

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8. Ibid., p. 145.

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13. Ibid.

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