July 14, 2008

VIA FACSIMILE AND E-MAIL

Defense Acquisition Regulations System
Attn: Ms. Sandra Morris
OUSD (AT&L) DPAP (CPF)
IMD 3D139
3062 Defense Pentagon
Washington, D.C. 20301-3062


Dear Ms. Morris:

On behalf of the Section of Public Contract Law of the American Bar Association ("the Section"), I am submitting comments on the above-referenced Defense Federal Acquisition Supplement (DFARS) interim rule issued with a request for comments by the Defense Acquisition Regulations System on May 13, 2008. The Section consists of attorneys and associated professionals in private practice, industry, academia, and government service. The Section’s governing Council and substantive committees contain members representing these segments to ensure that all points of view are considered. By presenting their consensus view, the Section seeks to improve the process of public contracting for needed supplies, services, and public works.

1 Jeri Kaylene Somers, James A. Hughes, Jr., and Sharon Larkin, Council Members of the Section of Public Contract Law, and Mary Ellen Coster Williams, the Section of Public Contract Law’s representative to the ABA House of Delegates, did not participate in the Section’s consideration of these comments and abstained from voting to approve and send this letter.
The Section is authorized to submit comments on acquisition regulations under special comment authority granted by the Association's Board of Governors. The views expressed herein have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, therefore, should not be construed as representing the policy of the American Bar Association.²

BACKGROUND

The Department of Defense (DoD) reported and published an Interim Rule amending the DFARS in order to implement Section 852 of the National Defense Authorization Act for Fiscal Year 2007. Pursuant to Section 852, DoD is required to issue regulations that address excessive pass-through charges on DoD contracts and subcontracts to ensure that such charges are not excessive in relation to the cost of the work being performed.

The DoD published that interim rule on April 26, 2007, 72 Fed. Reg. 20758 (Apr. 26, 2007) ("2007 Interim Rule"), and included a solicitation provision and a contract clause requiring offerors and contractors to identify the percentage of work that will be subcontracted. If the subcontracted costs are expected to exceed 70 percent of the total work, additional information is to be provided on indirect costs, profit, and the value being added to the subcontracted work. The DoD received comments from fourteen sources, including comments from the Section, which are attached.³ As a result of its review of the comments, DoD issued a second interim rule on May 13, 2008. 73 Fed. Reg. 27464 (May 13, 2008) ("2008 Interim Rule"). The Section respectfully submits these additional comments to highlight what it believes to be important points for DoD to consider prior to the release of a final rule.

COMMENTS

In its comments on the 2007 Interim Rule, the Section noted that it agrees pass-through charges should not be excessive. The Section has examined the extensive discussion of the comments submitted by fourteen sources on the 2007 Interim Rule and commends DoD for its thorough review of the comments and the

² This comment letter is available in pdf format at http://www.abanet.org/contract/federal/regscomm/home.html under the topic “Subcontracting and Teaming.”

³ The Section's previous comment letter, dated June 25, 2007, also is available in pdf format at http://www.abanet.org/contract/federal/regscomm/home.html under the topic “Subcontracting and Teaming.”
issues raised by that interim rule. In its comments on the 2007 Interim Rule, the Section addressed the importance of guidance regarding the effective implementation of the rule. In its notice accompanying the 2008 Interim Rule, however, DoD has deferred this issue to a point “when necessary.” As discussed in more detail below, the Section calls to DoD’s attention the January 2008 Government Accountability Office (GAO) report that makes the same recommendation. In addition, the Section does not believe that the DoD has addressed the conflict between DoD policies that the Section identified in its comments on the 2007 Interim Rule. The Section also suggests that the Final Rule include a threshold for flowing down the clause in subcontracts.

A. Guidance Should be Available to Contracting Officers, As Noted in the Section’s Earlier Comment and in a More Recent GAO Report

In its comments on the 2007 Interim Rule, the Section recommended that DoD provide guidance to contracting officers so that they can effectively implement the goal of eliminating or reducing excessive pass-through charges, which is an important goal. In the discussion of “Planning and Guidance” in the notice accompanying the 2008 Interim Rule, DoD mentions the Section’s statement that there is no substitute for adequate contract planning and administration on the part of the Government, and further relates the Section’s concern that without adequate guidance, there is potential for mischief. The DoD response states that “DoD will monitor implementation and will provide guidance when necessary.” 73 Fed. Reg. at 27471. To ensure that the 2008 Interim Rule is implemented in an effective manner and is not employed merely to reprice contracts, the Section repeats its recommendation that DoD proactively address the creation of guidance to assist contracting officers.

Since the Section submitted its comments on the 2007 Interim Rule, GAO, at the request of congressional committees, conducted a study because one-third of DoD’s fiscal year 2006 spending on goods and services was for subcontracts. As a result, DoD auditors and Congress raised concerns about the potential for excessive pass-through charges by contractors. 5 GAO reviewed and analyzed the Federal Acquisition Regulation, the DFARS, discussed the issues with DoD acquisition policy, audit and contracting officials, and interviewed private companies. As a result of this extensive review, GAO recommended that DoD issue guidance to

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5 Id.
implement this rule and noted that DoD concurred with the recommendation. Notably, the GAO report states that:

While the rule aims to provide contracting officers with more information on contractor value added, it alone will not provide greater insight into DOD’s supply chain and costs—information that companies told us they use to mitigate excessive costs. In addition, while the rule is not yet final, contracting officials we spoke to indicated the need for guidance on how to effectively implement the rule since they were not clear what more they should be doing beyond applying tools in the FAR and DFARS. This would ensure that contracting officers, particularly newer and less experienced staff, consistently apply federal acquisition tools in conducting their assessments of contractor value added and take into account contract risk when determining the degree of assessment needed, documenting assessments, and involving DCAA and DCMA as appropriate.  

The Section believes that the GAO report further supports the need for guidance at the time of implementing this requirement as a final rule, and recommends that DoD reconsider its intent to provide guidance “when necessary.” The GAO report provides information and suggestions relevant to the creation of guidance such as a description of unique circumstances that drive contracting arrangements that include greater risk of excessive pass-through charges, including the lessons learned on contracts awarded for Hurricane Katrina recovery efforts, which, the Section noted in its earlier comment, was one of the excessive pass-through situations that gave rise to the statutory requirement for this DFARS rule.  

Evaluation of a program’s cost and a contractor’s proposed management approach, including the subcontract plan, is a part of the procurement contracting officer’s award determination. The Section believes that to the maximum practical extent—for those procurements that are not otherwise exempt under the 2008 Interim Rule—any excessive proposed costs related to subcontract management can be evaluated in the context of competition or addressed in negotiations in a sole source procurement. The Section further believes that the new rule should serve as

\[6\] Id. at 4.

\[7\] Id. at 14–17.

\[8\] See Section Comments on 2007 Interim Rule at 5 n. 3.
a tool to ensure consistency to the extent practicable between contractors’ proposals, as evaluated by the procurement contracting officer, and actual performance, monitored by the contracting officer, rather than to serve as a basis to disallow cost after incurrence.

With further regard to evaluation of negotiated procurements, the procurement contracting officer should, in light of the 2008 Interim Rule, pay special attention to those contract elements that would require multiple tiers of subcontractors and thus, multiple layers of indirect cost and profit. For example, contracts that require the prime contractor to act as an integrator implicitly require that the prime contractor employ subcontractors to accomplish the scope of the contract. A more explicit example would be the requirement to satisfy a small business plan that could necessitate multiple subcontractors. Finally, the final rule should carefully consider the potential effects to those small businesses performing as prime contractors on contract set-asides given that small business prime contractors could experience significant adverse financial impacts as a result of disallowed pass-through costs under this rule. This would be contrary to the protections typically afforded small business federal contractors.

B. **The Interim Rule Does Not Reconcile Conflicts with Existing Policies**

In its comments on the 2007 Interim Rule, the Section noted that the 2007 Interim Rule could impact team assembly and formation decisions, and that it conflicts with DoD policy that seeks both to ensure robust competition for subcontracts and absence of bias on the part of prime contractors toward in-house sources. The Section recommended that DoD reconcile its policies to avoid confusion.

In the discussion of “Impact on Business Strategy, Spares Contracting, and Indefinite-Delivery Indefinite-Quantity or Delivery Order Contracts” in the notice accompanying the 2008 Interim Rule, DoD mentions the Section’s concern. DoD states that the policies are not inconsistent, and that this “rule is intended to protect the Government from those situations where there appeared to be an agreement with the contractor to perform the contract scope of work, including ‘managing’ subcontractors, and then after award, the contractor subcontracts substantially all the effort without providing the required ‘added value.’” 73 Fed. Reg. at 27470. The Section believes that the 2008 Interim Rule goes far beyond such situations. DoD’s statement connotes a situation where there is active misrepresentation of the prime contractor’s intent and perhaps its capabilities. The 2008 Interim Rule, however, addresses much more than misrepresentation, and reaches all situations where subcontracting can be used to create a strong team.
Nevertheless, DoD’s response does not address the Section’s concern. The Section supports the Wynne Memorandum’s purpose, which is to foster competition through assembly of a strong team that can address and satisfy the required capabilities while avoiding the favoring of an affiliate over an unrelated entity. The Section remains concerned that the 2008 Interim Rule exerts pressure to keep work in-house to address the reporting requirement, and believes that DoD should be aware – and concerned – about this. It seems inconceivable that the 2008 Interim Rule would not have an impact on contractor team assembly and formation decisions. The Section restates that the 2008 Interim Rule’s emphasis on limiting the amount of subcontracted work conflicts with the Wynne Memorandum’s emphasis on ensuring robust competition to ensure consideration of subcontracting to independent companies. As the Wynne Memorandum indicates, a key DoD goal is to facilitate the most effective combination of complementary skills to ensure that the prime contractor can provide best value and accomplish the task efficiently and effectively. If the amount of subcontracting is limited to an arbitrary share of the total work effort, this goal will be seriously jeopardized.

Additionally, the 2008 Interim Rule may be interpreted and applied so as to conflict with the requirements of the Cost Accounting Standards (CAS). CAS requires that all indirect costs be fully absorbed and allocated to final cost objectives, and defines certain mandatory rules for the measurement, assignment, and allocation of those costs. The 2008 Interim Rule provides a basis for contracting officers to disallow costs if the contractor fails to demonstrate “added value,” which is defined in DFARS 252.215-7004(a) as “... subcontract management functions that the Contracting Officer determines are a benefit to the Government.” Under the 2008 Interim Rule, the contracting officer is responsible for determining the value certain allocable indirect costs actually add to the contract. Nevertheless, General and Administrative (G&A) costs are by their very nature residual and do not permit the assignment of a clear beneficial or causal relationship between the cost incurred and a benefit to any particular final cost objective. As a result, there is a potential that the G&A applied to all tiers of subcontractors could be deemed to be “excessive” and therefore unallowable, even if it is incurred in accordance with the contractor’s approved disclosed cost accounting practices. If a contractor incurs cost in accordance with CAS and its disclosed practices, the only question should be the allowability and reasonableness of the cost, both of which can be dealt with prior to award and incurring of those costs.

9 On July 12, 2004, Michael W. Wynne, then-Under Secretary of Defense, Acquisition, Technology and Logistics (acting), issued a memorandum for the secretaries of the military departments entitled Selection of Contractors for Subsystems and Components (“Wynne Memorandum”).
To the extent a contracting officer believes that an adjustment to the amount of indirect cost applied to final cost objectives is appropriate because certain contracts receive more or less benefit from residual expenses than would be indicated by the contractor's standard allocation practices, those should be addressed through special allocations, such as those at 48 C.F.R. 9904.410-50(j) and 9904.418-50(f), not through the disallowance of costs.

The Section believes that a distinction should be made with regard to G&A applied to contracts versus applied profit. This will serve to protect the contractor's recovery of allowable G&A if incurred in accordance with CAS and the contractor's disclosed practices, while focusing the Government's attention to the negotiated item of profit. Application of indirect cost, including G&A, is not only governed, but required by the CAS and FAR. While public law and regulation determine the manner in which a contractor may apply those costs, they provide no methodology or guideline for the calculation and application of profit beyond justifying its existence. As a result, guidance should be issued to contracting officers to evaluate applied profit more stringently rather than to determine unallowable those actual costs that have been incurred and allocated in accordance with applicable guidelines.

C. A Threshold Should be Stated for Subcontracts That Must Flow Down the Clause

The summary of comments accompanying the 2008 Interim Rule demonstrates the value of reasonable parameters with regard to the number of subcontractors to whom this requirement flows down. The Section suggests that it is reasonable that subcontracts that are minimal in value or less than one to two percent of the total cost of the contract should be exempt.

DoD's response to these comments indicates that it agrees that a minimum threshold is required and that it has established a threshold tied to the cost or pricing data threshold. This establishes a threshold at the prime contract level. DoD did, however, include a threshold for subcontracts in paragraph (f) of DFARS 252.215-7004. As a result, prime and higher tier subcontractors through each tier of the supply chain will be required to include the clause in every subcontract, regardless of value, except for those that meet the four exclusions currently identified in the clause. Given that the clause requires contracting officers to make determinations with regard to subcontracts as well as the prime contract, the potential burden for satisfying this requirement with respect to low value subcontracts will be considerable. While many low value subcontracts may be awarded on a competitive basis or fit the definition of commercial items, many will not. The risk to the Government is minimal with respect to lower tier
subcontracts. If DoD uses the threshold in FAR 15.403-4, it will exclude a
significant number of subcontracts from this burdensome requirement, but still
cover the vast majority of the total value of subcontracts.

CONCLUSION

The Section supports the goal of the 2008 Interim Rule on excessive pass-
through charges, but remains concerned that without additional guidance, issues
will arise in the implementation of the final rule. Also, the Section recommends
that DoD reconcile the 2008 Interim Rule with the policies reflected in the Wynne
Memorandum and that it address a threshold for subcontracts.

The Section appreciates the opportunity to provide these comments and is
available to provide additional information and assistance as the Councils may
require.

Sincerely,

Patricia A. Meagher
Chair, Section of Public Contract Law

cc: Michael W. Mutek
Karen L. Manos
Donald G. Featherstun
Carol N. Park-Conroy
John S. Pachter
Michael A. Hordell
Robert L. Schaefer
Council Members, Section of Public Contract Law
Chair(s) and Vice Chair(s) of the Strategic Alliances,
Teaming and Subcontracting Committee
Chair(s) and Vice Chair(s) of the Accounting,
Cost and Pricing Committee
Scott M. McCaleb
Kara M. Sacilotto