January 29, 1999

Dear Ms. Haberlin:

On behalf of the Section of Public Contract Law of the American Bar Association ("the Section"), I am submitting comments on the above-referenced matter. The Section consists of attorneys and associated professionals in private practice, industry and Government service. The Section's governing Council and substantive committees contain members representing these three segments, to ensure that all points of view are considered. In this manner, the Section seeks to improve the process of public contracting for needed supplies, services and public works.

The Section is authorized to submit comments on acquisition regulations under special 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.

Background

Since the late 1980s, a number of defense contractors have restructured their business operations in conjunction with business combinations to increase efficiencies and enhance their competitiveness in the defense marketplace. Such restructuring efforts have led to reduced costs and future savings. Because of the complexity of such restructured operations, significant time lapses can occur between the announcement of the business combination and the point where the estimated restructuring savings are formally incorporated into new forward pricing rates. The General Accounting Office ("GAO") report titled, "Restructuring Costs Paid, Savings Realized, and Means to Ensure Benefits" (GAO/NSIAD-99-22, December 1, 1998), recommended that contracting officers be required to incorporate reopener clauses in noncompetitive fixed-price contracts that are negotiated before the benefits of restructuring savings are reflected in forward pricing rates. The proposed rule proposes to amend DFARS 231.205-70, External restructuring costs, to specify that contracting officers should consider including a downward-only repricing clause in such contracts.

Comments

The proposed rule does not mandate that contracting officers include a repricing clause in noncompetitive fixed price contracts negotiated prior to the inclusion of estimated restructuring savings in forward pricing rates. We believe that the DAR Council is correct in deciding not to mandate use of such a clause, and recommend that the DAR Council consider rescinding the proposed rule altogether. If the DAR Council decides to promulgate a rule, however, the rule should provide more specific guidance to contracting officers on the circumstances in which use of such a clause would not be appropriate.
The proposal seems to assume that, because the offeror's official forward pricing rates have not incorporated the estimated savings reflected in the contractor's formal restructuring proposal, the noncompetitive fixed-price contract is negotiated on the basis of the forward pricing rates in place prior to the announcement of the business combination. However, this is not necessarily the case. When negotiating noncompetitive fixed-price contracts during the window of time between the announcement of the business combination and the formal revision of the forward pricing rates to incorporate the impact of restructuring, the parties may have made reasonable projections of restructuring costs and savings, based on the best information available at the time of the negotiation. The contract price may thus reflect the estimated restructuring savings. Inclusion of a repricing clause in a firm fixed-price contract in this circumstance would be unwarranted and would be particularly inequitable if, as proposed, only downward adjustments were permitted. A downward only adjustment would not be appropriate or equitable in a circumstance where, for instance, costs on individual contracts have increased although there were savings in the aggregate. Also, as discussed further below, restructuring may result in a short-term increase in costs before the aggregate savings begin to accrue.

The proposal also seems to assume that a fixed-price contract's appropriate share of restructuring savings can be more or less accurately identified at the time that forward pricing rates are revised. The GAO, in an earlier report ("Defense Contractor Restructuring: DOD Risks Forfeiting Savings on Fixed-Price Contracts", GAO/NSIAD-98-162, July 17, 1998) observed that it took an average of about 21 months from the announcement of a business combination to the time that contractors reflected restructuring savings in forward pricing rates. Clearly, forward pricing rates adopted 21 months after the announcement of the business combination would reflect not only estimated restructuring savings but also new estimates of business volume, new accounting practices or business processes that are unrelated to the business combination, as well as numerous other variables. Indeed, the December 1998 GAO report readily acknowledges the challenge of isolating the effects of restructuring from the effects of nonrestructuring-related factors. Inclusion of a reopener clause does not lessen the difficulty of adjusting the price of a noncompetitive fixed-price contract solely to reflect restructuring costs and savings. At best, it merely postpones this difficult exercise.

The proposed rule applies only to fixed price contracts. The bedrock concept of fixed price contracting is that the parties agree on a fixed price and then, during performance, share the risk that their cost estimates may not be accurate. We are concerned at what appears to be a trend to increase the number of circumstances in which the price of fixed price contracts can be "adjusted" by the Government. If we are to depart from the bedrock concept of fixed-price contracting for restructuring costs and savings, then at the very least it should be possible to adjust the price in the contractor's favor as well as the Government's. Thus, if the proposed rule is retained, the limitation to downward-only adjustments must be removed. This limitation is inconsistent with DFARS 231.205-70 (as well as its statutory counterpart), which allows the costs of external restructuring if appropriate overall net savings to DoD will result. It is possible that, in the short term, there will be an overall increase in costs as restructuring commences, followed by reductions in costs. It is likely that costs on individual contracts could increase although DoD is still receiving the benefit of net overall savings. Under a "downward only" mandate, DoD would ensure that it received the benefit of the net savings while denying the contractor recovery of the costs necessary to achieve the savings. This is not what either the statute or the regulation contemplate, and it is not good policy.

Negotiations associated with a contractor's proposed restructuring costs and savings are often protracted. Consequently, the period between the announcement of the business combination and submission of the contractor's restructuring proposal can be considerably shorter than the period between the announcement of the business combination and the date on which the contractor's forward pricing rates are formally revised to reflect the impact of restructuring. In those cases in which the negotiated contract price includes no consideration of restructuring costs and savings, and revised forward pricing rates lag behind the restructuring proposal, the repricing clause should offer the option of determining the price adjustment based on the difference between (1) the forward pricing rates in effect on the date of the business combination, and (2) those same rates adjusted solely for the restructuring costs and savings reflected in the contractor's restructuring proposal.
In conclusion, we urge the DAR Council to withdraw the proposed rule. Since both parties know about the restructuring, neither side can precisely predict the impact, and both parties can estimate the costs and savings and negotiate a price accordingly, we do not believe the need for the rule has been demonstrated. If the DAR Council chooses, however, to proceed with this proposal, the limitation to downward only adjustments must be removed. In addition, we offer the following specific suggestions for improving the clarity and equity of the proposed rule:

1. A new paragraph (f)(2)(a) should be inserted which states:

   If the negotiated contract price reflects the parties' estimate of expected restructuring costs and savings, based on information available at the time of contract negotiation, incorporation of a repricing clause in the contract is not appropriate.

2. Paragraph (f)(2) should be renumbered as paragraph (f)(2)(b) and revised as follows:

   If the negotiated contract price does not reflect any estimate of expected restructuring costs and/or savings, the repricing clause should provide for an equitable price adjustment to ensure that DoD receives its allocable share of restructuring costs and/or savings as determined in accordance with this regulation.

3. Insert the word "also" following the word "will" in the second line of paragraph (f)(3).

Finally, the proposed rule applies only to noncompetitive fixed price contracts. Thus, the contracts to which the rule applies are also subject to the Truth in Negotiations Act ("TINA"). We believe the rule should specify that it does not apply in the case of contracts exempt from TINA, including commercial item acquisitions and those for which there is adequate price competition, as well as contracts for which TINA waivers have been granted. The DAR Council may also wish to consider the compatibility of the proposed rule with DoD's price-based contracting initiative.

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

Sincerely,

David A. Churchill
Chair, Section of Public Contract Law

cc: Rand L. Allen
Gregory A. Smith
Norman R. Thorpe
Patricia A. Meagher
Marshall J. Doke, Jr.
Marcia G. Madsen
John T. Kuelbs
Agnes P. Dover
Council Members
Chair and Vice Chairs, Accounting, Cost and Pricing Committee
Alexander J. Brittin