Developments in Cost and Pricing Issues

2016 Year in Review

November 8, 2016

Agenda

- Introduction
- Recent developments
  - IR&D
  - Commercial items
  - Case law updates
  - Regulatory updates
  - Employment law compliance updates

Introduction

- 2016 has been a significant year in the area of accounting, cost and pricing
  - DCAA is only 18 months behind on its incurred cost audits and can now begin assisting non-DoD agencies with audits (MRD No. 16-PPD-008(R) Sept. 30, 2016))
  - Congress considered a DoD CAS Board (FY 2017 SASC NDAA, Sec. 811)
  - DoD continues its assault on IR&D
  - The commercial item saga continues
  - Case law developments: contracting officers must more fully assess materiality of CAS changes
  - Some significant regulatory developments: counterfeit parts and rework cost allowability, FCA penalties increased dramatically
  - DCAA withdrew Chapter 7 of the DCAM and replaced it with its FAR Cost Principles Guide

IR&D Cost Allowability

- Recent DFARS final rule makes IR&D cost allowability contingent upon compliance with certain reporting and oversight requirements (81 Fed. Reg. 78,008 (Nov. 2016))
- Beginning in contractors' FY 2017, IR&D costs are allowable on DoD contracts, if prior to incurring IR&D costs, contractors:
  - Provide summary information regarding ongoing and completed IR&D projects to ACO and DCAA; and
  - Communicate proposed IR&D efforts to appropriate DoD personnel by means of a "technical interchange"
- Rule applies to major contractors (i.e., those allocating more than $11M in IR&D and B&P costs to covered-contracts in the prior FY)

IR&D Cost Allowability

- Rule lacks fundamental details
  - What constitutes a technical interchange?
  - Who is an appropriate technical or operational DoD employee?
  - How far in advance must a technical interchange be scheduled?
  - How will DoD protect proprietary contractor data?
- Unclear what purpose the rule serves
  - Asserted purpose is to ensure that contractors and DoD have sufficient awareness of each other's efforts and to provide industry with feedback on the relevance of proposed IR&D efforts
  - DoD acknowledges that it is not approving IR&D projects, but its potential unwillingness to engage in technical interchange renders IR&D costs unallowable
  - Appears to erode independence of contractor IR&D projects

IR&D Cost Allowability

- In light of new DFARS requirements, contractors should
  - Identify the DoD employees authorized to conduct technical interchanges
    - Office of the Assistant Secretary of Defense for Research and Engineering is default
  - Engage the appropriate DoD employees on what constitutes a sufficient technical interchange and discuss any potential scheduling issues
    - Consider what documentation will DCAA require to prove technical interchange occurred
  - Assess the financial viability of IR&D projects
    - Rule provides new grounds for audit attacks, which increases the financial risk associated with IR&D costs
  - Take steps to protect any proprietary information that may be discussed during these technical interchanges
    - Consider what level of detail is sufficient
    - Consider whether a nondisclosure agreement is appropriate

Offer Price Adjustments for Future IR&D Costs

- Proposed DFARS rule addresses DoD's apparent concern that offerors may gain an unfair price advantage when future IR&D efforts are used to “substantially reduce” the bid price on competitive procurements (81 Fed. Reg. 78,014 (Nov. 2016))
- Proposed rule requires:
  - Contracting officers to adjust total evaluated offer price upwards to the extent a contractor intends to rely upon future IR&D costs to reduce its proposed price; and
  - Offerors to provide documentation in their price proposals to support price adjustments for anticipated IR&D cost reimbursements
- Proposed rule applies to competitive procurements above the simplified acquisition threshold, but does not apply to procurements of commercial items

Offer Price Adjustments for Future IR&D Costs

- Proposed rule appears at odds with established DoD policy
  - DoD appears to take the position that IR&D costs are contract costs, which they are not
  - Proposed price adjustments appear to penalize contractors for conducting IR&D relevant to competitive government procurements
  - Appears to require contractors to provide cost or pricing data in connection with competitive procurements
  - Ignores the fact that contractors are permitted to use IR&D, undertaken at their own risk, to gain a relative price and technical advantage (*Raytheon Co. v. United State*s, 809 F.3d 590, 593 (Fed. Cir. 2015))
  - The fact that contractors are not required to complete IR&D projects does not present a significant risk to DoD because contractors are required to perform contracts or risk default
  - DoD fails to recognize the risks contractors take when conducting IR&D projects

Offer Price Adjustments for Future IR&D Costs

- Proposed rule is devoid of certain basic information
  - Should IR&D costs expected to be reimbursed by non-DOD agencies be included in the total evaluated offer price adjustment?
  - How should contractors account for future anticipated IR&D reimbursements?
- Proposed rule is likely to stifle contractor investment in IR&D projects
  - Significantly reduces contractor incentives to engage in IR&D
  - Creates potential protest issues related to how offerors identify and/or value anticipated IR&D cost reimbursements
  - Creates audit risks stemming from how proposal representations and anticipated IR&D reimbursements must be accounted for

The Commercial Items Saga

- Commercial item contractors face a challenging legislative and regulatory environment
  - When it comes to determining price reasonableness for commercial items, Congress and DoD appear headed in opposite directions
  - Congress appears intent on
    - Removing barriers to entry for commercial item contractors
    - Streamlining processes for commercial item determinations
  - Conversely, DoD appears set on
    - Limiting commercial item determinations
    - Increasing the use of cost data to support price reasonableness determinations

The Commercial Items Saga Timeline

- DPAP issues interim guidance (Feb. 2015) under FY 2013 NDAA
  - Concept behind the commercial items TINA exception is that prices are fair and reasonable as a result of demand in a commercial market
  - Key consideration is “Am I paying a fair and reasonable price?” not whether the item is a commercial item
- DOD issued proposed rule (80 Fed. Reg. 45,918 (Aug. 2015)), implementing FY 2013 NDAA, which would have
  - Allowed COs to request extensive information to justify price reasonableness
  - Created new definitions for “market-based pricing” and “sufficient government sales to establish reasonableness of price”
  - Required prime contractors to obtain “whatever information is necessary” from subcontractors to support price reasonableness determinations
- Significant narrowing of commercial item definition by effectively removing “offered for sale” from definition
  - Created significant compliance obligations for prime contractors
  - Foster disputes between prime and subcontractors over cost/pricing data

The Commercial Items Saga Timeline

- Congress responds in FY 2016 NDAA
  - Secretary of Defense required to:
    - Establish and maintain a centralized capability with the necessary expertise and resources to oversee the making of commercial item determinations (CID) for the purposes of procurements by the DOD
    - Provide public access to DOD CIDs
    - Establishes presumption that prior CIDs are sufficient for subsequent procurements
    - CO decision to disregard prior CIDs requires review by head of contracting agency
    - Provide report to Congress containing all DoD specific requirements applicable to commercial item procurements, with explanations and justifications
  - As a result, DOD rescinded proposed rule in Dec. 2015

The Commercial Items Saga

- DoD issues proposed rule requiring contracting officers to conduct market research in order to make price reasonableness determinations (81 Fed. Reg. 53,101 (Aug. 2016))
  - Market research shall be used to inform price reasonableness determinations
    - Market research is defined as "review of existing systems, subsystems, capabilities, and technologies that are available or could be made available to meet the needs of DoD in whole or in part"
  - Contracting officers may rely upon prior CIDs made by DoD and its components
  - Supplies and services provided by nontraditional defense contractors may be treated as commercial items
    - Intended to enhance defense innovation and create incentives for cutting-edge firms to do business with DoD
  - Contracting officers may still request "information that is sufficient to determine the reasonableness of price"

The Commercial Items Saga

- Proposed rule still presents challenges for commercial item contractors
  - Requirement for market research appears at odds with Congressional preference for commercial items
  - Definition of market research ignores relevant commercial pricing conditions, such as commercial businesses' operating models, profits, and expected margins
    - Overly focused on existing industry capabilities
    - Contrary to Congress' intent to expand DoD's opportunities to do business with innovative commercial companies
  - Focus on prior CIDs by DoD is overly narrow
    - CID by any government agency should be sufficient
  - Contracting officers' ability to obtain any information necessary to determine fair and reasonable price is overly broad
    - Does not appear based upon FY 2013 NDAA requirements
    - Potential scope of government request is unclear

The Commercial Items Saga

- DCMA has stood up its Commercial Item Centers of Excellence
  - Contracting officers should adopt the practice of recognizing prior CIDs
  - If a contracting officer believes a prior CID was without foundation, or was made in error, they should engage both their chain of command and the DCMA Commercial Item Center of Excellence before making a determination that deviates from prior decisions
  - The Director of Defense Pricing and the DCMA's Cost & Pricing Center Director are working with interested companies to define, through the use of advance agreements, the types of information needed to support commercial item determinations
  - Thus far, lack of timely action by DCMA to make CIDs
  - To the contrary, DCMA appears hesitant to make CIDs
    - Creates pricing issues, particularly down the supply chain
    - May result in DCAA recommending decrements

GSA Transactional Data Reporting

- GSA final rule requires contractors to report, on a monthly basis, transactional data related to orders placed against FSS, GWACS, and Government-wide IDIQ contracts (81 Fed. Reg. 41,104 (Jun. 2016))
  - Purpose is to provide GSA with heightened market intelligence
  - Transactional data is information generated from government procurements
  - Eliminates requirements for commercial sales practices disclosures and with price reduction clause tracking (assuming these requirements are removed from relevant contracts)
  - Applicability
    - Immediately applies to new GWACS and IDIQ contracts
    - May be applied to existing GWACS and IDIQ contracts
    - Implemented on pilot basis for FSS contracts (only certain schedules)
  - GSA launching new portal to facilitate reporting

GSA Transactional Data Reporting

- GSA final rule, while an improvement, contains its own flaws
  - Likely to result in increased contract administration costs for GSA and contractors
    - Particularly for small businesses
  - Final rule remains poorly defined
  - Susceptible to misuse
  - Release of contractor data "to the maximum extent practicable" is troubling
    - Only data releasable under FOIA
    - Nevertheless, contractors should be cognizant of data provided through portal and potential competitive impact

Case Law Update

- *Raytheon Co.*, ASBCA No. 58068., 2016 WL 4764637 (Aug. 9, 2016)
  - Contracting officer abused her discretion by failing to consider the materiality criteria in the CAS regulations at 48 C.F.R. 9903.305
  - Violation of FAR 30.602's mandate to assess the materiality of a cost impact under the CAS regulations
  - Contracting officer determined materiality based only on the fact that there was a cost impact to the government
  - Likely bolsters contractor assertions of immateriality
- *BAE Sys. S.F. Ship Repair*, ASBCA No. 58809, 16-1 BCA ¶ 36,226
  - DCAA audits are not admissions on behalf of the government
  - Government ordered a change near the end of performance, and DCAA's audit did not question any of the claimed costs for these changes
  - "[T]he DCAA audit does not constitute an admission on the part of the government but is only one piece of evidence in determining damages"

Case Law Update

- *Vistas Constr. of Ill., Inc.*, ASBCA No. 58479, 16-1 BCA ¶ 36,236
  - Contractor failed to establish that it could retroactively use a value-added base instead of historical total cost input base
  - Contractor not entitled to:
    - Prompt Payment Act interest penalty
    - Majority of consultant costs
  - Additionally, “serious question as to whether Vistas was in a litigation posture the entire time, which would bar it from recovering REA preparation costs;” ultimately, about 75% of REA preparation costs were denied as unreasonable

Regulatory Updates

- Counterfeit Parts Cost Allowability (81 Fed. Reg. 59,510 (Aug. 2016))
  - Final rule expands the safe harbor for allowability of the costs of counterfeit or suspected counterfeit electronic parts and any related rework or corrective action
  - In order for costs to be allowable:
    - Contractor must have a DoD-approved counterfeit electronic part detection and avoidance system
    - Parts must be GFP or obtained from an original manufacturer, authorized supplier, supplier that sources parts exclusively from either, or a “contractor-approved supplier”
    - Contractor must become aware of the counterfeit electronic parts through inspection and testing, a GIDEP alert or other means
    - Contractor must provide the contracting officer and GIDEP written notice within 60 days.
- FCA penalties nearly doubled
  - DOJ issued interim rule increasing FCA penalties (81 Fed. Reg. 42,491 (Jun. 30, 2016))
    - Minimum per-claim penalties increased to $10,781 from $5,500
    - Maximum per-claim penalties increased to $21,563 from $11,000

Employment Law Compliance Updates

- Additional employment law requirements
  - Minimum Wage (Exec. Order No. 13658): employees on certain government contracts must be paid $10.20 effective Jan. 1, 2017; exception for providers of goods
    - Notice of increase published at 81 Fed. Reg. 64,513 (Sep. 2016)
  - Fair Play and Safe Workplaces (Exec. Order No. 13673): contractors must disclose violations of labor and employment law under contracts over $500,000 for the previous three years
    - This information will be used in making a responsibility determination during selection
    - Final rule implemented at 81 Fed. Reg. 58,562 (Aug. 2016)
    - Federal court recently enjoined certain provisions of rule (*Associated Builders and Contractors of Southeast Texas v. Rung*, No. 1:16-CV-425-MAC (E.D. Texas Oct. 24, 2016))
  - Paid Sick Leave (Exec. Order No. 13706): beginning in 2017, contractors must provide paid sick leave to employees
    - Employees shall earn one hour of leave for every 30 hours worked; must be able to earn at least seven days per year
    - Final rule implemented at 81 Fed. Reg. 67,598 (Sep. 2016)

Questions?

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