OMB Circular A-76 in 1998:
Its Context and Its Structure ©

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Today's Anomaly

To borrow a phrase that we all know well, these are the best of times and the worst of times. It all depends upon where you are.

> The federal budget is now moving towards balance and everywhere there are demands for providing better public services for the same or less money. The federal civilian workforce is now the size that it was during the Kennedy Administration, and the demands on military readiness have in many respects increased since the end of the cold war. The U.S. economy has enjoyed a stable period of record low inflation and unemployment; and the prospects domestically look quite promising even though there are legitimate concerns about financial and domestic events occurring in Russia, Asia, Japan, and Brazil. If you are a taxpayer and have a stake in the American economy, these are good times. Yet, if you happen to work in the Department of Defense (DOD) or for a civilian agency that is downsizing to meet lower budget targets, these are not particularly happy times. DOD has announced that it intends to study at least 230,000 of those positions managed competitions under the auspices of OMB Circular A-76 with estimated saving approximately $6 billion per year.

The Legislative Backdrop

GPRA and the CFO Act

The move towards making the government more efficient and better managed has been going on for some time now. In recent years, Congress enacted the Chief Financial Officers (CFO) Act and the Government Performance and Results Act , Pub. L. 103-62, (GPRA) for performance based management and accountability. Under GPRA, each executive branch agency must issue strategic plans that lay out long term goals the agency will pursue as well as the agency strategies to achieve those goals. The first of these strategic plans were provided to Congress in 1997. Each agency is then to develop annual performance plans that identify the agency's annual goals and strategies as well as the resources that will be used to achieve those yearly goals. The first of these plans, to cover fiscal year 1999, were submitted to Congress earlier this year (1998).

In establishing its annual performance plan, the Office of Management and Budget (OMB) and the Congress expect an agency to consider use of a number

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of management tools including OMB Circular A-76 (the Circular) in determining what the agency is trying to achieve and how best to achieve it. The General Accounting Office (GAO), issued a guide in February 1998 for the Congress to use in assessing annual performance plans. In that guide, GAO noted that Congress:

> "… could examine the plans from the standpoint of whether they show evidence that various approaches, such as establishing partnerships with other organizations and contracting, were considered in determining how best to deliver products and services. More directly, the annual performance plans can provide a ready-made, annual vehicle for Congress to use to inquire about agencies' efforts to ensure that the most cost-effective strategies are in place to achieve agencies' goals. As part of this inquiry, Congress can ask agencies about the tools the agencies are using to increase effectiveness, including the status of A-76 programs, and the specific choices the agencies have made whether to keep a commercial activity in-house or contract it out."

GAO has also roundly criticized the budget and accounting practices of all the agencies in testimony on the Circular' Oversight and Implementation given by its Associate Director, Federal Management and Workforce Issues, General Government Division, before the Senate Subcommittee on Oversight of Government Management, Restructuring and the District of Columbia, Committee on Governmental Affairs:

> The government's lack of complete cost data, particularly indirect costs, has increased the difficulty of carrying out the A-76 competitive process, because the government is not able to accurately determine the cost of the function or activity it plans to compete. The cost data needed to develop indirect costs factors that represent these costs, such as overhead rates, are not readily available. In our audit of the consolidated financial statements of the U.S. government for fiscal year 1997, we noted significant financial management deficiencies. We found that financial weaknesses; problems with fundamental recordkeeping; incomplete documentation; and weak financial controls, including computer controls; prevent the government from accurately reporting a large portion of its assets, liabilities, and costs. These deficiencies affect the government's ability to accurately measure the full cost and financial performance of programs and to efficiently manage its operations. For example, in January 1998, we reported that DOD has no reliable means of accumulating actual cost data to account for and manage resources. Moreover, in a February 1998 report, we noted that it will likely be many years before DOD is capable of providing accurate and reliable cost data.

GAO recognizes that efforts are under way to improve government cost data and supporting systems, but for some agencies it could be several years before significant improvements are made:

> Continuing efforts to implement the Chief Financial Officers Act (CFO Act) are central to ensuring that agencies resolve their long-standing problems in generating vital information for decisionmakers. In that regard, the Federal Accounting Standards Advisory Board (FASAB) has developed a new set of accounting concepts and standards that underpin OMB's guidance to the agencies on the form and content of their agency wide financial statements. [The FASAB was created in October 1990 by the Secretary of the Treasury, the Director of OMB, and the Comptroller General to consider and recommend accounting principles for the federal government. If accepted by Treasury, OMB, and GAO, the standards are adopted and issued by OMB and GAO. A counterpart to the FASAB standards are the Cost Accounting Standards (CAS) which are issued by the Cost Accounting Standards Board (CASB) and which are binding upon larger "CAS covered" private sector companies and organizations that do business with the government.]
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> As part of that effort, FASAB developed managerial cost accounting concepts and standards. These managerial cost accounting concepts and standards require that federal agencies provide reliable and timely information on the full cost of federal programs and on their activities and outputs. Specifically identified in the standards is the need for information to help guide decisions involving economic choices, such as whether to do a project in-house or contract it out. Such information would allow agencies to develop appropriate overhead rates for specific operations. These cost accounting standards became effective for fiscal year 1998. Some agencies' Chief Financial Officers have expressed concern about their agencies' ability to comply with the cost accounting standards this year.

In February 1998, the Joint Financial Management Improvement Program (JFMIP) - which is a joint and cooperative undertaking of the Department of Treasury, the GAO, OMB, and the Office of Personnel Management (OPM), operating under authority of the Budget and Accounting Procedures Act of 1950, issued a document entitled "Managerial Cost Accounting System Requirements." In its introduction, the JFMIP explains:

> This *System Requirements for Managerial Cost Accounting* document …builds upon, and provides a means to implement, requirements related to cost accounting set forth in the Chief Financial Officers Act (CFO Act), Government Performance and Results Act (GPRA), Statements of Federal Financial Accounting Standards (SFFAS), Office of Management and Budget (OMB) circulars, and other sources…The document establishes the standard.

Governmentwide system requirements hat an agency should consider for systems supporting managerial cost accounting functions, but also allows flexibility to address agency-specific requirements, such as those associated with the choice of costing methodology (e.g. activity-based costing.)

SSFAS Number 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government,* requires reporting entities to perform at least a certain minimum level of cost accounting and provide a basic amount of cost accounting information necessary to accomplish the many objectives associated with planning, decision making, and reporting. This minimum level includes collecting cost information by responsibility segments, measuring the full costs of outputs, providing information for performance measurement, integrating cost accounting and general financial accounting with both using the Standard General Ledger, providing the appropriate precision of information…,and accommodating any of management's special cost information needs that may arise due to unusual or special circumstances.

SSFAS Number 4 defines a cost accounting system as a continuous and systematic cost accounting process which may be designed to accumulate and assign costs to a variety of objects or as desired by the management. Even if the agency is using [commercial off-the-shelf] software, agency management still needs to make decisions regarding the cost objects to be defined, the costing methodology to be used, the types of costs to be included for each reporting or decision making purpose (e.g., full cost), and other items of a similar nature.

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…SSFAS Number 4 says, "In managing federal government programs, cost information is essential in the following five areas: (1) budgeting and cost control, (2) performance measurement, (3) determining reimbursements and setting fees and prices, (4) program evaluations, and (5) making economic choice decisions…The concepts section of SSFAS Number 4 states that cost information should be presented using the appropriate basis of accounting (e.g., accrual) and recognition/measurement standards for the intended use of the information. Using different bases of accounting and cost accounting methods can produce different costs for the same item, activity, or entity, which can confuse users of the information. Therefore, a key concept is that reports using different accounting bases or different methods for recognition and measurement should be reconcilable. And should fully explain those bases and methods.

…The managerial cost accounting system must capture (or share with other systems) all data on costs needed to determine the costs of outputs and the total net cost of the entity's operations, with the appropriate disclosures of the components of net cost…[w]ith respect to each responsibility segment, the costs that are to be assigned to outputs include: (a) direct and indirect costs incurred within the responsibility segment, (b) costs of other responsibility segments that are assigned to the segment, and (c) inter-entity costs recognized by the receiving entity and assigned to the segment.

The Evolution of the Federal Activities Inventory Reform (FAIR) Act and the Full Cost Recovery Debate

During the 104th Congress, two bills (S. 314 and HR 1724) designed to promote outsourcing and privatization were advanced but not enacted. They came back to life in the 105th Congress (1998) in the form of S.314 sponsored by Senator Craig Thomas and a House counterpart sponsored by Representative Thomas Duncan and popularly known as the Freedom from Government Competition Act or the Thomas-Duncan Bill. (As discussed later in this paper, the legislation evolved into the Federal Activities Inventory Reform (FAIR) Act which was signed by the President on October 19, 1998.) The legislation gained favor after reports of the ICEMAN procurement infuriated certain members of the private sector In that procurement, the Federal Aviation Administration (FAA) awarded a data center contract worth up to $250 million to the Agriculture Department's National Information Technology Center in Kansas City under a reimbursable ISSA. The Center competed against IBM, Computer Sciences Corporation (CSC), and a third private sector firm as well as ISSA proposals from the Defense Information Systems Agency (DISA) and the Department of Transportation's Administrative Service Center (TASC). Although not covered by the Circular, the FAA conducted the procurement using some of the Circular's approach including the best value source selection criteria which was to make contract award to the lowest-cost, highest-quality support.

Questions were immediately raised such as how could there be a common basis for comparing offers among the entities if they do not have common accounting practices. The Government follows FASAB and is supposed to be implementing the CFO Act to establish overhead rates whereas IBM and CSC are subject to CAS. FASAB does not require the Center to fully allocate costs to a business unit whereas CAS does require every CAS covered contractor to fully allocate costs. The Center did not have to account for its bid/proposal costs whereas IBM and CSC did have to include those costs in their overhead pools. The Center does not pay taxes or pay for insurance. IBM and CSC do pay taxes and insurance, and they must also account for earning a profit.

In recognition of these and other cost disparities, the Chief Financial Officers Council had already begun addressing the need for a level playing field for industry and government as the entrepreneurial franchise organizations began to compete against private industry for administrative support services. The CFO Council developed 12 operating principles for business-like federal organizations. They stressed the need for full and open competition, with franchises organizations operating on a self-sustaining basis with "full cost recovery" and no "captive" customers such as home agencies.

The Best Value and Past Performance Debate

Another issue also lurked in the background dealing with the procurement concepts of best value and past performance. Under the Federal Acquisition Streamlining Act (FASA) and the Federal Acquisition Reform Act (FARA), federal agencies are now encouraged to award contracts using a source selection methodology known as “best value” and using a company’s (not its individuals) “past performance” as a major evaluation factor.

Aside from placing increased emphasis on past performance skills or capability, the concept of best value is not new. There is a long line of Comptroller General Procurement Decisions upholding the ability of federal agencies to award a contract to the offeror (best value does not apply in the case of sealed bidding or advertised procurement) whose proposal reflects the best overall approach to satisfy their requirements, regardless of whether it is the lowest-priced proposal. This is done by having the Contracting Officer make a cost or price versus technical trade-off in a formal context. Before passage of FASA and FARA, contracting personnel traditionally relied upon the “lowest-priced technically acceptable” approach to source selection as the simplest and most readily defensible means of awarding a negotiated procurement competition. Then, in a series of high profile bid protests decided by the General Services Board of Contract Appeals (GSBCA) under the Competition in Contracting Act (CICA) and the (now defunct) Brooks Act, the GSBCA engaged in what many considered to be greater scrutiny of, and required more detailed information from, agency source selection officials than was considered appropriate as compared to the more reserved manner in which GAO traditionally reviewed bid protests involving best value decisions. GAO traditionally shows a great deal of deference to agency award determinations and will not substitute its judgment for that of the source selection officials so long as the agency’s evaluation had a reasonable or rational basis.

The questions raised about use of best value related directly to the manner in which he USDA's price was calculated and whether its price fully or accurately represented the USDA's costs to allow the FAA source selection officials to make a valid cost or price versus technical trade-off.

The questions raised about past performance were equally troublesome. Until passage of FASA and FARA, a company's past performance was generally examined only in the context of a "responsibility" determination. Contracting officers who were confronted with a contractor with a record of past performance that was marginal or successful but less than excellent had to decide whether or not to reject the bid or offer on a finding of nonresponsibility. Unless the contractor had a completely unsatisfactory record of past performance, the contracting officer almost always found the contractor to be responsible.

With the enactment of FASA and FARA, past performance was elevated from a matter of responsibility to a legitimate source selection evaluation factor in negotiated procurements. This became a matter of critical concern for contractors. A contractor with a less than excellent record of past performance will not score as well as one with an excellent past performance record. As a result, even contractors with a good record of performance may not win in a competition against a contractor with an excellent past performance record. In order to clarify some of the confusion about what "past performance" means, the Office of Federal Procurement Policy (OFPP) issued guidance documents (OFPP Policy Letter No. 92-5 and OFPP's May 1995 "Interim Guide to Best Practices for Past Performance") about the ability and appropriateness of federal agencies establishing and maintaining information about contractors' past performance. The OFPP guidance calls for six areas of performance to be rated: (1) quality of product or service. (2) timeliness of performance, (3) cost control, (4) business practices, (5) customer satisfaction, and (6) performance of key personnel. Agencies are asked to evaluate contractor performance at the completion of each contract and at interim points if the contract term exceeds 12 months. The guidance also states that contractors should be given the opportunity to review and comment on performance ratings. If a contractor disagrees with an evaluation, it should be able to request a review at a level above the contracting officer.

The ICEMAN Procurement

The question presented by the ICEMAN procurement was how to deal with the USDA in the context of a past performance evaluation. The OFPP guidance states clearly that a new entity or one without a corporate record of contractual past performance should be rated as neutral. How, then, could USDA have been competitive with IBM and CSC, companies with significant past performance records?

As reported in an article that appeared in the September 1997 edition of the Government Executive, "In the Ring" by Michael D. Serlin, this became front page news in the Washington Post and elsewhere:

> "…industry officials complained that the bids hadn't been properly adjusted to account for taxes and other factors. FAA delayed implementing the pact to determine whether contracting officials had fully complied with Office of Management and Budget Circular A-76 guidance on calculating whether services can be provided more cost-effectively by private firms. In early June, the USDA Center was confirmed the winner.
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> Then Congress got into the act. A previously unheralded measure, the Freedom from Government Competition Act (S. 314) assumed a higher profile. Witnesses and spectators turned out in force when its sponsor, Sen. Craig Thomas, R-Wyo., held June [1997] hearings on the bill before a Senate Governmental Affairs subcommittee. [OMB officials disagree with this account by noting that the FAA did conduct customer surveys and applied the appropriate adjustments called for by the Circular including accounting for taxes and applying the 10% cost differential.]"

The FAIR Act's Details

The legislation has evolved since then to the point that it now is called the FAIR Act of 1998. It calls for each federal agency, on an annual basis, to submit to OMB a list of activities which are not inherently governmental and are performed by Federal employees. Rather than leaving the term "inherently governmental" to be applied by each agency as it chooses subject to guidance provided by OFPP Policy Letter 92-1, the legislation creates a statutory definition – identical to the OFPP guidance – to ensure uniformity among the agencies. After consultation with and review by OMB, OMB will make the list publicly available and publish a notice of that availability in the Federal Register. The bill also requires the list to be transmitted to Congress and updated whenever there are changes, and it establishes an "appeals" process within each agency for "interested parties" to challenge what is on and not on the list. Interested parties include actual or prospective offerors, representatives of any business or professional associations representing public sector franchises or private sector offerors, and labor unions.

Further, the bill requires an agency, within a reasonable period of time, to review an activity on the list and, when competing activities, to use a competitive process to select the source to perform the activity. While the legislation does not specifically refer to A-76, it is clear that OMB is free to use A-76 to satisfy the competitive process requirement. Hence, the legislation would support the Circular on a statutory basis.

With respect to costs, the legislation calls for "realistic and fair cost comparisons." This is done by having the head of an agency ensure that "…all costs (including the costs of quality assurance, technical monitoring of the performance of such function, liability insurance, employee retirement and disability benefits, and all other overhead costs) are considered and that the costs considered are realistic and fair.

The Administration is satisfied with the FAIR Act because it does not delay or adversely affect ongoing or planned A-76 efforts, particularly in the Defense Department, and it appears not to provide for judicial review. Organized labor is equally pleased. The late John Sturdivant, president of the American Federation of Government Employees (AFGE), testified in June 1997 that his union, which represents almost 700,000 employees, is not opposed to competition, but simply wants to be among the competitors. Reportedly, after markup by the Senate Governmental Affairs Committee on July 15, 1998, the AFGE stated that it was "neutral" on the new legislation; and its position remained unchanged during the last push to get the measure enacted

Industry's Opposition

Industry is less sanguine about the legislation because many in the private sector have felt that A-76 has been an impediment to the goal of transferring government-performed commercial activities to the private sector. For example, the Chair of the Privatization Ad Hoc Group of the U.S. Chamber of Commerce, James A. Dobkin, wrote in a Bureau of National Affairs Special Supplement in November 1996:

> Paradoxically, one of the most significant barriers to privatization has been the very vehicle created by the federal government created by the federal government to foster it – A-76. Although revised in early 1996, A-76 still imposes a heavy burden on the government to justify outsourcing. For example, it requires that the performance of a government function by a commercial contractor result in at least a 10 percent savings in the government personnel-related cost of performing the same function. This "home field advantage," if you will, is not easy to overcome, especially under other ground rules required by A-76.
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> A-76 prescribes the performance of a cost comparison between the activity as performed "in-house", i.e., by government employees, versus the outsourced activity. Yet, this cost comparison process is conducted on an "uneven playing field" which gives the government entity an inherent advantage. Private vendors must protect themselves against financial, schedule, and performance risks by including contingency costs in their bids. A government entity has no incentive to include such a contingent cost factor, for if it exceeds its estimated "price" because of unanticipated problems encountered during performance or poor performance, no loss is incurred – the additional costs are simply absorbed by the government.

> Thus, the in-house estimate in effect contemplates a no-risk, best efforts, cost-reimbursement contract, while the outside vendor must bid to a fixed-price contract for the same services."

In a draft White Paper written for the House Government Reform and Oversight Committee in February 1996, the National Council for Public-Private Partnerships observed:

> Various private contractors have also expressed the belief that the federal government should not compete with the private sector in the provision of commercial services. For example, the Contract Services Association of America, in its comments on the proposed OMB Supplement stated, "to the extent the government competes with and detracts from the private sector marketplace, the national interest is being ill-served." Several other associations representing private contractors have expressed similar views. In a letter to OMB dated September 5, 1995, and signed by representatives of the Aerospace Industries Association, the Electronic Industries Association, the American Consulting Engineers Council, the Information Technology Association of America, and the Professional Services Council, the associations state their view that the public/private competition is bad public policy and that OMB should shift from measuring resource input and activity to measuring results.

So What's the Big Deal About Costs?

As discussed previously, under the CFO Act and GPRA, the federal government is moving inevitably towards an accounting system that will allow it to track all of its costs at the responsibility center level. In accounting parlance, costs are allocated or assigned to "cost objects" which is typically an activity or item whose cost is to be measured. The JFMIP explains:

> In a broad sense, a cost object can be an organizational division, program, activity, task, product, service, or customer. However, the purpose of cost accounting by a responsibility segment is to measure the costs of its outputs. Thus, the final cost objects of a responsibility segment are its outputs: the services or products that the segment produces and delivers, the missions or tasks that the segment performs, or the customers or markets that the responsibility segment serves.

The JFMIP explains that there are four costing methodologies that can be used to assign costs to a responsibility segment: activity-based costing, job order costing, process costing, and standard costing. These costing methodologies are not mutually exclusive. Both activity-based costing and standard costing can be applied to job order or process costing systems.

Comparing Public Sector and Private Sector Accounting Theories

What the accounting guidance does not do is define the boundaries of a responsibility segment. Where do you draw the line for the purposes of assigning costs? Should a business unit involved with base operations at an Army installation in Arkansas be allocated the costs of operating the Pentagon? Should it be allocated the costs of supporting troops in Bosnia? Should it be allocated the costs of operating Air Force One?

There are many in the private sector who would argue that all costs of government should be allocated to each segment. Otherwise, how else can one fairly compare the costs for the government to perform a particular activity to the costs for a private company to perform that same activity. In support of this argument, they first refer to Generally Accepted Accounting Principles (GAAP) which require measuring a whole business for an entire accounting period. These standards are used primarily by independent Certified Public Accountants (CPAs) in making determinations of the reasonableness of a company's balance sheet for the whole business and income statement for the whole business for an entire accounting period. Next, they refer to the discipline of cost accounting which is that part of accounting which accounts for segments of a company's activities. Financial accounting is that part of accounting that deals with the whole of the company for a whole accounting period. Cost accounting is a logical extension of financial accounting as it controls the assignment of those expenses and revenues to accounting objectives within the company. For example, financial accounting controls how a company's depreciation expense for the year is computed. Cost accounting controls how that depreciation expense is assigned to the various segments of the company.

There are three main characteristics of a cost accounting system: (1) it provides a mechanism for recording the total cost of transactions (this is a characteristic of a financial accounting system as well); (2) it provides a basis for distributing the total cost measure of these transactions to the defined cost objectives; and (3) it provides data for the financial accounting system. Based on this language, it is clear that private contractors must account for all costs of the business and allocate those costs within the strictures of GAAP's financial and cost accounting principles.

In addition to being subjected to GAAP, Government contractors are also subject to the rules of the Federal Acquisition Regulations (FAR) including those involving costs under the Cost Principles found in FAR Subpart 31. Larger Government contractors are also subject to the Cost Accounting Standards (CAS). Under the FAR and CAS, contractors must account for all costs. In so doing, individual contractors have choices in developing accounting systems, including ways of differentiating between direct and indirect costs, selecting the number and content of overhead cost pools, and picking the method of allocating these overhead costs to cost objectives. Again, these rules require that all costs be considered and treated consistently.

Difficulties arise when attempts are made to compare private sector and public sector entities indirect costs. With respect to direct costs, there usually is no difficulty. FAR 31.202 defines a direct cost as any cost that can be identified specifically with a particular final cost objective. They normally include the salaries and wages of performance or management personnel directly associated with these cost objectives with associated fringe benefits, materials directly used in providing the service or product, and subcontract costs related to the cost objective. The rules governing public sector accounting generally follow this logic; and, therefore, as previously indicated, there is usually little room for disagreement.

Turning to indirect costs, they are all costs that cannot be specifically identified with units of output at the time they are incurred because cost either is incurred for more than one unit of output or is not susceptible to measurement at the unit of output. Indirect costs are commonly separated in to overhead and General and Administrative (G&A) costs. Overhead costs are those not directly related to cost objective but are support-type costs necessary for normal operations such as expenses for salaries and wages of support and administrative personnel, facilities expenses, and general supplies. Overhead costs may be accumulated into overhead pools. The number of pools can vary depending on the complexity of operations. Each overhead pool is allocated to cost objectives in reasonable proportion to the beneficial or causal relationship of the pooled costs to cost objectives. G&A costs are any management, financial, and other expense which is incurred by or allocated to a business unit and which is for the general management and administration of the business unit as a whole. G&A costs normally include compensation of executives and their related fringe benefits, legal and professional fees, and other administrative personnel and costs. G&A costs are frequently accumulated in a single pool and allocated to the entire business unit based on the total cost by way of a prescribed rate.

The above language on indirect costs comes from the FAR and applies to Government contractors. The question is whether it can or should apply to Government agencies. As a matter of course, these ‘pools’ do not exist in today’s public sector accounting systems – yet. They will emerge as compliance with the CFO Act occurs. When one is engaged in an A-76 cost comparison process, costs are allocated for comparison purposes; but otherwise these pools do not exist for accounting or budgetary purposes. An even more important issue is how best to identify these costs on the Government side of the ledger when conducting a fair cost comparison. Two central issues arise. First, how do you define a government business unit? The private sector by necessity has to include the entire enterprise regardless of size and then break it down into various business segments or lower echelon business units. The Government does not have to be as inclusive. As it is not a business enterprise and consists of sovereign functions, there are some elements that cannot and should not be outsourced (i.e. inherently governmental). Second, how do you handle the issue of idle labor and idle facilities? DOD has excess capacity now, and as ISSAs pursue new work in competition with the private sector, can the ISSAs tap into this capacity for bidding purposes as an unpriced asset?

The Kelly Air Force Base Competition

This was a central issue – even the dispositive issue - in the recent Privatization-in-Place competition that occurred at Kelly Air Force Base in San Antonio last year. (It is important to note that the Kelly depot base closing privatization decision was not subject to A-76.) Historically, the Air Force considered the capacity to maintain and repair its most vital equipment as too critical to its mission to allow outside of its direct control. However, with the five Air Logistics Centers (ALC) operating at less than 50% capacity, it became clear that some facilities would have to close despite the Air Force's arguments that it needed this organic capacity in case of a surge in military activity. In 1995, against Air Force advice, the Base Realignment and Closure Commission (BRAC) decided that the ALCs at McClellan and Kelly Air Force Bases should be closed and the work reallocated among the remaining ALCs in Oklahoma, Utah, and Georgia. This triggered immediate consternation not only within the Air Force but also the White House which was concerned about the loss of jobs in California and Texas. There were more than 11,000 civilian workers employed at McClellan near Sacremento, and more than 14,000 were employed at Kelly.

To avoid political repercussions, the Administration hit upon the notion of Privatization-in-Place. In an article that appeared in the Spring 1998 edition of MIT's Security Studies Program Breakthroughs journal, Jeremy Shapiro wrote:

> Privatization-in-Place essentially means selling assets of the depot into private hands in exchange for a promise that certain personnel levels will be maintained for a limited period of time. Similar privatizations, on a smaller scale, are currently being implemented or already have been completed at the Air Force's Aerospace Guidance and Metrology Center in Newark, Ohio, the Naval Warfare Center in Indianapolis, and the navy Gun Center of Excellence in Louisville, Kentucky.
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> The concept of privatization-in-place has several advantages for both the executive and the military. For the executive, it offers the opportunity to avoid the unpleasant implications of the BRAC decisions without violating the letter of the BAC mandate. President Clinton has claimed that privatization-in-place would retain at least 8,700 jobs at McClellan and at least 16,000 jobs at Kelly through

> 2001. For the Air Force, privatization permits them, if not to maintain an organic capacity at its present level, at least to preserve a proven surge capacity and perhaps to save some money that might be shifted toward modernization, instead of repair.

When the competition was conducted, the winner between the competing private sector offers and the Air Force offer from Warner-Robbins Air Force Base in Georgia turned out to be Warner-Robbins. The Air Force won, and the work remained in-house - but in Georgia, not San Antonio. So, the workers in San Antonio lost. Had the work gone to one of the private contractors offering to perform the work, the Air Force would have "lost," but the work would have stayed in San Antonio. On the other hand, excess capacity was eliminated, economies of scale prevailed, and he union was pleased with the result. When all was said and done after the inevitable challenges, it turned out that the Air Force did not include the cost of idle facilities or labor at Warner-Robbins in calculating its costs. Were it a private contractor subject to GAAP and CAS, it is hard to imagine how the contractor could avoid including such costs into its cost proposal for fear, at least, of dire audit consequences. Had the Air Force fully accounted for idle labor and facilities properly, the outcome of the competition may very well have been different – and this especially would have been the case had the rules of A-76 applied, especially in light of the FAIR Act.

To give this some balance, there are those who maintain that the numbers can be rigged to make privatization and outsourcing appear more attractive than they should. For example, take the case of Newark Air Force Base, Ohio, where in 1993 the Air Force announced it would close the base and privatize in place the navigational guidance repair work conducted by 1,400 workers at the facility. GAO looked at the Air Force's projected one-time closing cost and projected that it had doubled. Writing in the Government Executive in December 1995, James Kitfield said:

> In fact, GAO concluded that contracting out the work at Newark might actually cost $456 million more over the next five years than having the Air Force do it…[David Warren, a GAO investigator, stated]…For instance…the Air Force used models based on outright base closure to calculate savings, and therefore equated personnel costs to non-recurring costs. When those personnel costs started recurring as a payment to a private sector company, the projected savings figure declined, and took years longer to realize.

There are other examples that reflect the disconnect between public sector and private sector accounting methodologies which lead to distorted results. The case of Pemco Aeroplex, Inc. which was recently decided (B-275587.9, June 29, 1998) by the General Accounting Office in a bid protest denial illustrates the point.

In July 1996, the Air Force issued a request for proposals for programmed depot-level maintenance for the C-130 in Europe, the continental United States, and the Pacific. In

April, it awarded a contract for the United States to Aero Corp.; and Pemco protested. GAO ruled in favor of Pemco based on a finding that the Air Force's past performance analysis was inadequate, and the Air Force decided to have the work performed in-house by Warner Robbins Air Logistics Center on a temporary basis. This turned into a more permanent arrangement when the Air Force announced in March 1998 that it was canceling the RFP and dividing the work in-house between Warner Robbins and Ogden Air Logistics Center in Utah.

Pemco and Aero protested this decision to GAO contending that the cancellation was based on a flawed business case analysis and that the Air Force could not perform the work less expensively than could either of the private contractors. Although the Air Force's action was not undertaken pursuant to an official A-76 announcement and methodology, the Air Force claimed that it essentially followed certain aspects of an A-76 cost analysis in arriving at a determination that the Air Force could perform the work at a cost lower than could the private sector. On closer examination, however, it is clear that the Air Force did not follow the A-76 cost comparison process. The Air Force was also subject to the provisions of 10 U.S.C. 2462 that requires DOD to procure supplies and services from the private sector if doing so would result in a lower cost.

The GAO did not reach the question of whether the cost comparison was flawed despite a clear showing by the protestors that the Air Force did not include all relevant costs for Warner Robbins and Ogden when calculating the total costs for the Air Force. Had GAO been required to deal with this question directly, it is almost a certainty that GAO would have sustained Pemco's protest. Instead of dealing with the cost question directly, GAO was able to resolve the case by focusing entirely on another provision, 10 U.S.C. 2466a, which limits to 50% [it used to be 40%] the amount of depot-level work that can be contracted out to the private sector in any given fiscal year. Under the facts presented, the GAO agreed with the Air Force that for FY 1998, $3.112 billion is provided to public depots and $2.503 billion is provided to private contractors resulting in a difference of roughly $600 million. A shift of $300 million from the public sector to the private sector would potentially place the Air Force in violation of Section 2466a.

Despite this ruling, it is noteworthy that in examining the Air Force's own cost methodology, Aero was able to demonstrate that certain idle facility and idle labor costs (reflecting excess capacity and people who wold perform some of the work brought in-house) were not included in the Air Force's costs. Hence, when Aero's and Pemco's costs (which had to include all costs to perform the work including the facilities and labor that the Air Force did not consider) were totaled, the Air Force's costs looked cosmetically lower.

The bottom line is that the Air Force made a decision to bring certain C-130 aircraft maintenance work in-house using a cost comparison methodology that did not include all of the costs for idle facilities and idle labor. The Air Force's logic for not including those costs is that as a military service it has to have a standby capability to handle wartime surge situations and that it is unfair to penalize a maintenance business unit by having to carry these sustaining-type costs. A-76 permits certain work to be retained in-house and not be exposed to cost comparison; but once a decision is made to conduct a cost comparison, the rules call for a fair and level playing field. The private sector parries that argument by pointing to the rules governing costing and maintain that the government cannot have it both ways. If it is acting as a sovereign that has national defense responsibilities, then it should stay away from the competitive marketplace that has its own accounting rules calling for full costing and fair disclosure on a level playing field. If it is acting as an entrepreneurial center of government in the marketplace, it has to be subjected to the same rules that private sector firms must meet.

What is the Appropriate Accounting Approach?

These examples frame a critical accounting debate which is how to consider costs when comparing costs between in-house and contracted services at military installations. The accounting literature recognizes three types of costs to consider: fully allocated, avoidable, and marginal.

An in-house fully allocated (or total) cost, which has been discussed at length above, is the sum of the direct costs for the cost object plus a proportional share of organizational overhead (or indirect costs). Direct costs include salaries wages, and ODCs as well as items routinely overlooked such as interest costs, pension costs, and facility and equipment costs. Overhead costs are generally apportioned among government services, programs and activities according to some allocation scheme. The most common methods are based on headcount, total direct costs, and the “step-down” method. The headcount method assumes that overhead is proportional to the number of employees. The total direct method assumes overhead is proportional to the budget of the target service. The step-down method divides all departments into either support or production departments, and allocates all the costs of support departments to the other entities they serve.

The total cost of contract service delivery is the sum of the contractor’s costs (its proposed price), plus contract administration costs, and plus an allowance for one-time conversion costs, minus off-setting revenues (new or enhanced revenue streams that will come to the government as a result of contracting out a target service such as new taxes).

According to Lawrence Martin writing in March 1993 for the Reason Foundation:

> [Use of fully allocated costs] are appropriate in evaluating the operating efficiency of a public provider. Comparing the fully allocated cost of the in-house provider with the anticipated total cost of contracting is useful in assessing their relative efficiency. If the fully allocated costs of the public provider are more than ten percent greater than for a private contractor, that service merits further consideration for [outsourcing]. Fully allocated costs, however, are not the

> correct measure for estimating the likely cost savings through [outsourcing], as fully allocated costs tend to overestimate savings, especially in the short term.
>
> The use of fully allocated costs is generally inappropriate in estimating savings between the fully allocated in-house costs and the total contracting cost. This is because contracting out does not generally result in a dollar-for-dollar reduction in governmental overhead costs. For example, the contracting out of a target service, or portion thereof, may result in decreasing the workload of service departments like personnel, finance, and facilities management; but the workload reductions may be insufficient to have any significant effect on the costs of maintaining these departments.

Avoidable costs are those in-house costs that will not be incurred if a target service, or portion thereof, is outsourced. Virtually all direct costs are avoidable, but it is much more difficult to determine avoidable overhead costs. Mr. Martin observes:

> How-to contracting books, as well as several contracting-out guides prepared by state and local governments, recommend the use of avoidable costs when assessing the likely cost savings achievable through contracting out. The use of avoidable, or incremental costs is also the generally accepted managerial accounting approach to conducting the financial component of a business “make-or-buy” decision.

The difficulty with avoidable costs is that the private sector usually responds rapidly in reducing overhead when direct costs fall whereas the public sector is not as nimble for a variety of reasons including civil service protection and institutional inertia. Being driven by the bottom line, private entities need to react quickly whereas public sector entities rely on appropriated sums. In addition, organizations do not realize avoidable costs unless a substantial amount of the target service is outsourced. If there are only small amounts of work involved, there will be a negligible impact on overhead. Moreover, there may be costs that can be avoided in the long term but which must be incurred in the short term.

Given these limitations, the literature still suggests that cost savings using the avoidable cost theory is the preferred methodology to follow in measuring overhead savings. Indeed, as will be discussed below, A-76 has adopted this methodology for measuring costs under the federal managed competition program.

A third approach is marginal costing. A business entity planning to enter a new line of business has the choice to provide the work in-house or to contract out for it. This "make-or-buy" decision is traditionally examined in the context of marginal costing which calls for the additional cost of providing the service in-house to be compared to the total cost of purchasing the service. Again, Mr. Martin observes:

> But what is sound business practice is not necessarily prudent for government entities, which do not operate in a competitive environment. For this reason, state and local governments desiring to promote public-private sector competition may find that basing in-house bids and proposals on fully allocated costs comes closer to creating a "level playing field." This is because, unlike a competitive enterprise, a public provider often maintains excess productive capacity. Business accounting theory assumes an efficient allocation of resources, and this assumption is often not valid for monopolistic public providers. The existence of surplus capacity in public providers tends to make estimates of the marginal cost unrealistically low. Assuming that an in-house department has surplus capacity and bids to perform a new service using incremental cost rather than fully allocated cost, it is difficult to imagine many scenarios in which a private-provider cost would appear competitive.
>
> This is true even for private providers that are far less expensive. The practice of comparing in-house marginal cost with the total cost of contracting has the practical effect of precluding private contracting. Therefore, in the case of new or significantly expanded service, governments wishing to promote competition should compare the fully allocated costs of the government agency against the total cost of the contracted service.

To add to the complexity, keep in mind that there are traditionally four different methods for conducting make-or-buy decisions: net present value (NPV), internal rate of return (IRR), payback period, and accounting rate of return. These are succinctly outlined in the treatise <u>Analyzing Outsourcing</u> (1995) by Daniel Minoli of New York University's Information Technology Institute.

The preferred method is NPV. The first step is to calculate the net cash flow generated by the project, starting with project revenues and subtracting expenses (other than depreciation), capital expenditures, and taxes. The net present value is the benefit that accrues to the organization from buying the specific equipment. It is the sum of the present values of all future cash flow minus initial cost. A positive net present value means that the project yields a rate of return that exceeds the cost of capital; a negative net present value means that the project earns less than the entity could obtain by keeping the money in the bank.

The IRR method looks only at the rate of return on the project. If the IRR is high, this is good. If it is low, the project may not go forward. If the IRR from the project is higher than what could be generated from a bank's interest rate for the cash flow involved, then there is a financial basis for going forward. The IRR method is not as good as the NPV method because selecting an alternative with the highest IRR is illusory. If one project has an IRR of 10 percent and another has a rate of 40 percent, the 10 percent project may still be the better approach when absolute dollar returns are taken into account.

The payback method is the length of time it takes to recover the initial investment. The payback period method postulates acceptance of a project payback only if the payback occurs more quickly than a predetermined timeframe. The one with the shortest payback period wins.

The accounting rate of return method, also called the return on investment (ROI), is the average annual after-tax accounting profit generated by the investment divided by the initial expense. This method is inferior to the NPV because it does not evaluate cash flows or take into account the cost of money.

The Bottom Line On Costs

So, having run through all of these rules and their complexities, what is the bottom line on costs? Clearly, there is a disparity in the way we approach costs; but there has been little reasoned discussion about the complexity in accounting methodologies as applied to our federal managed competition program regardless of whether the competitions occur under A-76 or not. Hence, when following the evolution of the cost related language in the FAIR Act, there are many who are concerned that the measure's language only appears to be dealing with total costs and that it covers all types of public-private-ISSA transactions. It fails to address the issue of excess capacity or the way in which differing accounting approaches should be reconciled for fair cost comparison purposes as a matter of public policy. Is there a difference between military and non-military agencies when it comes to retaining underutilized assets and personnel? It doesn't address which type of accounting methodologies should be used under what circumstances. It does not address whether there should be separate accounting methodologies to use in make-or-buy determinations and, if so, which one is preferred. There are a host of questions like these which need to be tackled in an intelligent, reasoned context.

With this in mind, the full text of the language in the FAIR Act is worth examining:

> Section 2 (e) Realistic and Fair Cost Comparisons. – For the purpose of determining whether to contract with a source in the private sector for the performance of an executive agency activity on the list on the basis of a comparison of the costs of procuring services from such source with the costs of performing that activity by the executive agency, the head of the executive agency shall ensure that all costs (including the costs of quality assurance, technical monitoring of the performance of such function, liability insurance, employee retirement and disability benefits, and all other overhead costs) are considered and that the costs are realistic and fair.

While the language is helpful, it could go much further – not by presenting a legislative laundry list of accounting rules but by creating a process for a uniform set of accounting rules to be used whenever public sector and private sector costs are examined in the context of a competitive cost comparison. OMB could step in to control the process and involve the JFMIP, the FASAB, and the CAS Board while wrestling with these issues collectively along with the best accounting minds from the public and private sectors? They could come back to the Congress or OMB with recommendations within a relatively brief timeframe, and then decisions can be made on fundamental public policy cost matters in a way that engenders trust in a truly "realistic and fair" competitive process. To its credit, OMB has played a significant role in shaping the legislation and creating a workable cost comparison process. Now it is time to move ahead with implementation.

OMB Circular A-76

Having laid the foundation through the above discussion about the costs controversy, let us turn to examine the A-76 Circular itself. When the need to downsize the military occurred some time ago during times of economic optimism and expansion, in 1955 the Eisenhower Administration introduced Bureau of the Budget Bulletin No. 55-4 which called for reliance on the private sector to perform commercial activities for needed goods and services. In 1966, the Office of Management and Budget (OMB) – the successor of the Bureau of the Budget, issued OMB Circular A-76 (the Circular). OMB updated the Circular several times including most recently in 1983. OMB also issued a Supplemental Handbook in 1979 that included detailed procedures for competitively determining whether commercial activities should be performed (1)in-house, (2) by another agency through an interservice support agreement (ISSA) (also known as "franchising" as that term is used in the 1994Government Management Reform Act (GMRA) , or (3) by the private sector. OMB revised the Supplemental Handbook in 1983, and then issued its latest version in March 1996. The latest version is intended to resolve many of the concerns about conducting competitions on a relatively level playing field and to make the process less burdensome on all players. The key is to introduce competition into the process and create the incentives necessary to achieve savings, improve efficiency, and maximize effectiveness.

The stated philosophy underlying the Circular expresses a clear preference to use the private sector in supplying products and services to meet the Government's needs when cost effective:

> In the process of governing, the Government should not compete with its citizens. The competitive enterprise system, characterized by individual freedom and initiative, is the primary economic strength. In recognition of this principle, it has been and continues to be the general policy of the Government to rely on commercial sources to supply the products and services the Government needs.

It is important to keep some key definitions in mind. Under the Circular and DOD pronouncements, A-76 is synonymous with the concept of managed competition. Managed competition means that in-house employees compete against other entities (the private sector and ISSAs) for the work. Outsourcing has been used synonymously with the concept of managed competition, but many are confused because some use the term to mean contracting out directly to the private sector without giving in-house employees the opportunity to compete for the work. Nevertheless, DOD uses the term outsourcing to mean managed competition under A-76. In contrast, when an agency decides not to continue a function or activity, it may then privatize the function or activity as in the case of an asset sale such as the recent creation of the U.S. Enrichment Corporation or the sale of the Elk Hills Oil Petroleum Reserves. Another variant on privatization is spinning off the in-house employees into an Employee Stock Ownership Plan (ESOP) company on either a stand-alone or business-combination basis.

While much is being said about privatization, less is actually being done at the federal level as compared to outsourcing under the Circular. This stands in marked comparison to privatization activity at the state and local levels of government in the U.S. One area, however, that may see marked change is in DOD utilities where the Deputy Secretary of Defense pronounced in his Defense Reform Initiatives (DRI) that DOD would be exiting ownership of all utilities – water, wastewater, electricity, gas, and steam - by 2000. Another area is information technology thanks to passage of the Clinger-Cohen Act, Pub. L. 104-106, (formerly the Information Technology Reform Act or ITMRA) which was passed in 1996 as part of the broader Federal Acquisition Reform Act (FARA).

Some agencies from the start have relied predominately upon the private sector such as the National Aeronautics and Space Administration, the Environmental Protection Agency, the Health Care Financing Administration, and the Department of the Energy. Others, such as the Department of Defense, the Veterans Administration, the Agriculture Department, and the General Services Administration are now moving aggressively to explore use of the private sector. This certainly appears to be the trend for the near term, and it is changing the way that industry and the government will do business. Government program managers will need to learn how to be effective contract managers and move away from supervisory roles and responsibilities that focused mostly on budget concerns and less on obtaining desired results through intelligent contract administration. Industry also will have to adjust as public/private managed competition opportunities along with performance based contracting become the norm.

DOD has projected that it can save approximately $6 billion annually by 2003 and $2.5 billion annually thereafter using the managed competition under the Circular. Currently, and in addition to the privatization of its utility systems, DOD plans to subject over 230,000 positions to the A-76 process in order to meet these ambitious goals. DOD has consistently reported savings from reviewing an agency's operations and making the changes to meet the competitive requirements of A-76 yield an average of 20 percent savings regardless of whether the work remains in-house or not. This is in line with the findings of the Center for Naval Analysis (CNA) in its 1993 Analysis of the Navy's Commercial Activities Program. CNA found that since 1979 the Navy's A-76 program reviewed about 29,000 billets of which roughly half were contracted out. The average cost study achieved savings of about 30 percent. Savings were close to 40 percent of the original cost of performing a function if that function was contracted out and 20 percent if it remained in-house.

The current A-76 process is presented in OMB's March 1996 Revised Supplemental Handbook. It is a complicated document that does not lend itself to quick reading, but it does attempt to strike a fair balance between the competing interests of the in-house workforce, ISSAs, and commercial contractors. It is not possible to present all of the nuances of the A-76 program here – we teach a three day basic course and a two day advanced course on the subject at the George Washington University Law School's Government Contract Program – but a quick overview is appropriate.

GAO describes the current program as follows:

> Circular A-76 and its supplemental guidance require agencies to evaluate their activities to determine whether they are [inherently] governmental or commercial [in nature] and complete an inventory of all commercial activities. A-76 requires, in certain circumstances, that agencies conduct cost comparisons to determine the most efficient means to carry out commercial activities. Under A-76, agencies are to use a three-step process to determine whether recurring commercial activities will be performed in-house or by contractors. The process consists of (1) developing a performance work statement [PWS] that defines the technical, functional, and performance characteristics of the work to be performed; (2) conducting a management study to determine organizational structure, staffing, and operating procedures for the most efficient and effective

> in-house performance of the commercial activity, referred to as the Most Efficient Organization of MEO; and (3) accepting formal bids [or proposals depending on the method of solicitation selected] and conducting a cost comparison between the private sector and the government's Most Efficient Organization in order to make a decision on whether an activity will be performed by the government or the private sector.

In June 1996, OMB requested that agencies submit not later than September 13, 1996, a summary of their updated inventory of commercial activities. OMB did not receive inventories from all agencies, and of those received many were based on old information. Most recently, in a May 12, 1998, memorandum, OMB asked agencies to submit updated lists of commercial activities by October 31, 1998. OMB plans to make the lists available for congressional and public review by January 1999.

Both GAO and the Congress consider the agencies' inventories of commercial activities to be central to the success of a rigorous A-76 program. GAO remains skeptical but encouraged by the Administration's new inventory initiative. The Congress has decided to underscore the importance of all of this by enacting the FAIR Act.

Each agency and service has its own approach to performing an A-76 cost comparison study, but the steps are substantially the same. The Navy's approach is illustrative of the process and is broken down into 15 steps as follows:

1. Plan for Commercial Activities Study

2. Develop PWS and QASP (coordinated with developing the Management Plan – see Step 7)

3. Review and Revise PWS and QASP

4. Obtain High Level Approval of PWS and QASP

5. Conduct Presolicitation Actions

6. Prepare and Issue Solicitation

7. Develop the Management Plan

8. Respond to Solicitation (Closing Date)

9. Perform Independent Review (Prior to Closing Date)

10. Evaluate Proposals (If an RFP was issued) or Open Bids (for IFBs)

11. Obtain Prenegotiation Clearance (for negotiated procurements where discussions are appropriate)

12. Conduct Discussions with Offerors

13. Obtain Final Clearance Approval for Selecting Best Value Contractor Proposal (if best value was the source selection methodology, which is usually the case for contractor source selection)

14. Compare Government and Contractor Proposals

15. Announce Tentative Decision

Typically, Step 1 occurs first and takes approximately 1 month. Step 5 begins next and lasts through to the issuance of the solicitation for contractor bids or offers. Steps 2 and 7 begin at the end of Step 1; and Step 2 ends with the issuance of the solicitation as is the case for Steps 3 and 4 which commence once the draft PWS is written and occur consecutively. Steps 6 and 8 occur while the solicitation process involving the private commercial contractors goes forward ending with the proposal evaluation process or bid opening. Step 9 also must be completed before bids or offers are received. Steps 10 through 15 occur next in consecutive order. The Navy hopes to complete the entire process in 12 months. Many believe that is a very aggressive timeframe given OMB's mandate that cost comparisons for single activities be completed within eighteen month or thirty-six months for multiple activities. Recent legislation now calls for the DOD to complete these studies within twenty-four and forty-eight months, respectively.

The Army follows a slightly different methodology, but the sequencing is essentially the same. The Army formalizes a data collection and analysis task prior to writing the PWS, and there is a separate step involved in drafting performance requirements prior to delivering the management plan. The Air Force has a more detailed approach which covers the same territory in a slightly different sequence.

As you can see, the competitive process is distinctive because it occurs on two tracks. For the in-house employees, the effort initially is focused on developing a PWS which serves as the scope of work and is the basis for all costs entered on the Cost Comparison Form. The key to the entire A-76 program is writing solid Performance Work Statements. This is a topic that has received a lot of attention by several agencies including NASA and the Office of Federal Procurement Policy (OFPP). OFPP issued OFPP Pamphlet #4 in October 1980 and has been working more recently on a guide to writing Performance Based Service Contracts. On July 13, 1998, OFPP issued a Notice of Availability of Draft Performance Based Service Contracting Documents on Selected Professional and Technical Services. NASA has a web site on the topic (http://www.hq.nasa.gov/office/procurement/perfase.htm) which is quite helpful.

Once the PWS drafting process is sufficiently mature but not yet completely done, the people who will staff the management plan effort begin their work in developing the MEO. At some point after the process to develop the MEO and Management Plan commences, the contracting officer will issue an IFB or RFP which contains the PWS in Section C of the solicitation document. The Management Plan also includes the QASP, an analysis of assets to be used by the MEO but which are not available to ISSAs or contractors, a transition plan from the status quo to the MEO, ISSA, or contractor, and the in-house cost estimate.

The Management Plan and MEO are considered to be procurement sensitive documents and are delivered as sealed documents to the contracting officer prior to the date that initial offers (for RFPs) or bids (for IFBs) are due from the private sector. No private sector offer or bid is opened or otherwise reviewed prior to the sealing of the Government's in-house estimate. Once delivered to the contracting officer, the Government's cost estimates are certified in writing by the agency's designated Independent Review Officer (IRO), or designee, as being in full compliance with the procedures and requirements of the A-76 Supplement. After certification, the Management Plan remains in sealed envelopes until the competitive process (usually conducted on a best value basis) for selecting the "winning" contractor is completed. At that point, the contracting officer must determine whether the PWS has evolved during the competitive contractor selection process by virtue of amendments to the solicitation documents or otherwise. If such a change has occurred, the in-house people in charge of the Management Plan must make all changes necessary to meet the revised and fnial PWS performance standards accepted by the Source Selection Authority. Once the changes are made, the final selection between the MEO and the “winning” private contractor (which could be an ISSA) is made on the basis of low price after taking into account the “minimum cost differential” which is the lesser of 10 percent of in-house personnel-related costs or not to exceed $10 million over the performance period. Factors such as decreased productivity, and other costs of disruption that cannot be easily quantified at the time of the cost comparison are included in this differential. By the way, in the event the A-76 competition involves a commercial contractor as the incumbent, the minimum cost differential works in favor of the incumbent.

The parallel source selection process for private contractors very much tracks the traditional procurement methodology outlined in the FAR. Generally, the procurements are negotiated using Request for Proposals, and the evaluation scheme is based on best value language with an emphasis on past performance. However, in recognition of the fact that the ultimate selection between the MEO and the private “winning” contractor will be based on low price; contractors who are aware that the final selection between the MEO and the private sector winner is based on low cost will typically not offer technically superior approaches that are more costly than lower quality, lower cost approaches which are nonetheless compliant with the terms of the PWS.

In negotiations between the Congress and the Administration over the language in S. 314, the Administration fought successfully to maintain this two track process – partly to ensure that the MEO was always involved in the last round of the source selection process but more importantly to maintain a level playing field when the government itself has a vested interest in the best value competition. Advocates for the private sector advanced the argument that the source selection process be conducted purely on a best value basis with an emphasis on past performance and superior technical approach. The Administration was concerned about the subjective nature of past performance given the Government’s historical performance and lack of records, particularly where the MEO was newly formed and would have only a neutral rating as was previously mentioned in the discussion about the ICEMAN procurement.

In arriving at the new cost comparison rules under the March 1996 Supplemental Handbook, OMB made a serious attempt to create a level playing field in the cost arena. It has chapters dealing specifically with how to handle ISSA participation in the process, how to prepare cost comparison estimates for government performance and contract performance, how to conduct streamlined cost comparisons for activities below a specified FTE threshold, and overall instructions on the A-76 methodology. However, when it comes to dealing with the major open issues (such as idle capacity and labor, or which accounting theory to apply under what circumstances) some argue that the drafters did not go beyond the accounting standards discussed above. However, the

Administration disagrees saying that A-76 if used properly does take these costs into account. It all depends upon implementation.

To the drafters credit, they attempted to move towards the full allocation of cost method as much as was practical:

> Competitions based upon output and cost performance measures must reflect the agency's fully allocated costs of performance and must be certified as being in full compliance with the Statement of Federal Accounting Standards No. 4, *"Managerial Cost Accounting Standards for the Federal Government."* The cost comparability procedures described in this Supplement, such as those related to fringe benefit factors, must also be considered in assessing the comparability of Government and private sector performance measures and costs. Adjustments to Government and private sector performance measures and costs may be required. Performance standards should be monitored in conjunction with the Chief Financial Officers Act (CFO Act) and the Government Performance Results Act of 1993 (GPRA).
>
> A cost comparison between in-house, contract or ISSA performance seems straight-forward, but, in fact, is complicated by the very different ways Government agencies and commercial sources account for cost. For example, the Government buys capital equipment and may recognize the entire expense when payment is made. The commercial sector may borrow funds and recognize the expense of capital equipment as it is used. All costs incurred by commercial sources are ultimately charged to a "customer," whereas agency costs may be met by several different appropriations accounts, revolving funds or mixes thereof. Insurance is a real cost of doing business in the commercial sector, while the Federal Government is a "self-insured entity." Taxes are paid by most commercial sources and received and used by the public sector. Assets are purchased from owners in the commercial sector, yet they are purchased by the taxpayer in the public sector. The Government may incur employee retained pay or save pay as a way of mitigating the adverse impacts of a management decision, without assessing these costs to the activity. The commercial sector passes these types of costs on to the customer. These and other differences necessitate cost comparison requirements that equalize the systems to reflect the total alternative costs to the Government and the taxpayer. Such costs may or may not be fully reflected by agency accounts.

Although this straightforward recognition on OMB's part (that it has been unable to treat similar costs in a similar fashion due to the differences between public sector and private sector accounting methodologies) is refreshing, it does not completely overcome some of the larger gaps in accounting logic. For example, the situation is clearly illustrated by turning to the treatment of overhead in the Supplement. The Supplement lumps operations overhead (those costs not 100 percent attributable to the activity under study) and G&A overhead together. The Supplement states, in Chapter 2, paragraph B.1.3, that Personnel costs "… may include certain management and oversight activities, such as personnel support, environmental or OSHA compliance management, legal or other direct administrative support costs. These costs are to be entered in Line 1 of the Generic A-76 Cost Comparison Form (CCF). The Supplement provides that Overhead costs are to be entered in Line 4 of the CCF and requires that these costs be calculated as a flat 12% of Line 1. The Supplement defines overhead as consisting of two parts. The first is operations overhead which are those costs that are not 100 percent attributable to the activity under study. The second is general and administrative (G&A) and includes salaries, equipment, space and other activities related to headquarters management, accounting, personnel, legal support, data processing management and similar common services performed outside the activity, but in support of the activity.

This is helpful language as far as it goes, but it does not draw the line in the same way that government contractors are forced to do under CAS 410.

CAS 410 deals with G&A expenses and the allocation of "Business Unit General and Administrative Expenses to Final Cost Objectives." This is a dry way of describing how to allocate "home office" costs such as centralized services, staff management of specific activities, central payments, and the like, are equitably distributed among all of the business segments of the enterprise. Contrary to the flexibility allowed by the Supplement in deciding how much of the costs get allocated to a business unit (note that the Supplement requires that only "certain" costs "may" get included in Line 1 and that this can vary from business unit to business unit even within the same agency or service), the private sector is subjected to the strict and rigid requirements of the Cost Accounting Standards. Hence, the public sector can decide on a case-by-case basis which costs are included in G&A and which are not for cost comparison purposes, whereas CAS 410 requires consistency in all circumstances and thereby handcuffs government contractors with the use of prescribed allocation formulas. This is accomplished typically through the use of the total cost input basis of arriving at G&A which is the generally acceptable measure of the total activity of the business unit. However, CAS 410 allows several alternatives such as value-added and single-element cost input. Regardless of which methodology is chosen, once a government contractor has fixed on a particular methodology, it cannot change without going through the costly and time-consuming process of making a formal cost accounting change complete with filing a revised accounting disclosure statement and cost impact analysis. No government agency faces such a restriction or penalties for CAS noncompliance.

In addition, CAS 418 constrains government contractors in the way that they determine, accumulate and allocate direct and indirect costs. Each business unit of a company must have a written statement of accounting policies for classifying costs as either direct or indirect. Indirect costs must be accumulated in homogenous cost pools, pools in which all significant costs have similar beneficial or causal relationships to cost objectives. Again, government contractors have some flexibility in deciding upon its allocation methodology. For example, the basis used for allocation depends on the type of costs included in the pool. If the cost pool consists primarily of managing direct labor activities, a direct labor hour or dollar base would be appropriate. If pool costs were primarily facility-related, such as depreciation, maintenance, or utilities, a machine hour base would be appropriate. However, once the rules on what is a direct cost versus and indirect cost is set and the allocation methodology established, the company cannot change them without going through the process described above.

In contrast, public entities are not so constrained in the way that they can move costs back and forth from direct to indirect on a situational basis within an agency or service. Therefore, they can treat each new competitive situation differently to keep direct and indirect costs cosmetically low for bid or proposal competitive purposes. This means that cost pools can vary on a situational basis and the allocation methodologies can be skewed to the advantage of the government unless care is taken by internal government reviewers to keep the process honest and consistent. It is especially difficult to police in the case of ISSAs which do not file Disclosure Statements analogous to what government contractors are required to submit and, therefore, can present costs to agencies not familiar with the way an ISSA handled similar costs in similar circumstances with another agency. The closest that the public sector has to govern this area of potential mischief are agency financial statements, but they do not approach the level of detail that CAS requires. And they certainly do not have penalties for noncompliance that begin to approach what government contractors face under CAS.

Aside from the differences in handling overhead matters, the Supplement's accounting resorts to use of the avoidable cost method for determining the cost savings to be realized should the activity be contracted-out. This is done by multiplying the costs of personnel, including fringe benefits, by 12 percent. Significantly, the Supplement applies this formula to all circumstances even though others would argue that there are circumstances, as discussed above, where fully allocated costing or marginal costing are more appropriate. This takes us back to the central issues of idle labor and idle capacity that drove the decisions in ICEMAN, Kelly Air Force Base, and the Aero/Pemco protest. As Mr. Martin pointed out in his Reason Foundation paper discussed above:

> When attempting to determine the potential cost savings associated with the contracting out of a target service, he appropriate in-house costs to use in the comparison are the "avoidable costs" [which are] those in-house costs that will not be incurred if a target service, or portion thereof, is contracted out. [However, when looking at a situation where an agency is seeking to expand its business base such as in the case of an entrepreneurial ISSA, it is more appropriate to use fully allocated costs.] Business accounting theory assumes an efficient allocation of resources, and this assumption is often not valid for monopolistic public providers. The existence of surplus capacity in public providers tends to make estimates of the marginal cost unrealistically low.

> Assuming that an in-house department has surplus capacity and bids to perform a new service using incremental cost rather than fully allocated cost, it is difficult to imagine many scenarios in which a private-provider cost would appear competitive. This is true for private providers that are far less expensive. The practice of comparing in-house marginal costs with the total cost of contracting has the practical effect of precluding private contracting. Therefore, in the case of new or significantly expanded service [as in the case of an ISSA situation], governments wishing to promote competition should compare the fully allocated costs of the government agency against the total cost of the contracted service.

Another area of strong controversy revolves around the treatment of bid and proposal costs. CAS 420 provides clear rules about identifying, tracking, and recording B&P costs; and commercial companies must account for them in their costs and prices. It sometimes costs hundreds of thousands of dollars or more for an commercial offeror to assemble a proposal in response to an A-76 opportunity. Yet, government agencies do not have to include the costs of their B&P into their cost or price considerations. The only language in the Supplement that comes close to addressing this issue appears in Chapter 2 where OMB states that "[t]he cost of conducting a cost comparison is not added to the in-house cost estimate or contract price." OMB maintains that B&P costs are included in the 12 percent overhead rate, but many would argue that 12 percent is far too low a number to begin with to allow a cost as significant as B&P to be embedded in that rate. Perhaps, with the new authority given it, OMB may consider addressing the issue and modifying the Supplement to account for this disparity, especially in the case of ISSAs.

Having said all of this, do these cost issues really matter? Do the competitions turn on these issues. As discussed above, the choice in accounting methodologies as it pertains to indirect costs can drive award decisions. At the same time, however, there is not that much difference in the area of wages and benefits despite much rhetoric to the contrary. In its report, CNA addressed this issue directly:

> When a contractor won a competition, we tried to understand the reasons why that contractor could bid below the government price. Lower wage rates did not seem to be the driving force behind most decisions. Contractors are required to pay wages set by the Department of Labor (DOL) for specific occupations. These wages are not necessarily identical to the wages paid to government employees, but there is no major competitive advantage due to lower wages in the private sector. It was suggested that fringe benefits might be lower for private sector employees, but there are DOL requirements for those as well.

One perceived advantage for contractors was the lack of civil service rules. The ability to expand and contract the work force quickly, whether that means making hiring and firing decisions or using part-time and temporary employees, was perceived to be much easier for contractors.

Some of those interviewed noted that contractors used people more efficiently. Whether this was due to the lack of unions, government work rules, or the mere profit motive was unclear, but contractors used fewer people and seem to demand more of their workers.

[With respect to competitions against military employees, CNA found that] contractors have two other advantages over military personnel that allow them to operate fewer personnel:

- Contractor personnel need not devote time to uniquely military duties
- They are not subject to the same deliberate turnover policies that military personnel are.

One final note on the A-76 process. Do not forget to notify Congress before embarking on a project that affects federal employees, even if you believe in good faith that the A-76 process technically does not apply. That is the hard lesson that was recently learned by the Army when the Army Materiel Command attempted to outsource the Logistics Systems Support Command (LSSC) during fiscal years 1998 and 1999 thereby reducing over 500 federal workers at Chambersburg, Pennsylvania and St. Louis, Missouri. Apparently, the Army planned to conduct a competition among private firms with the caveat that the winning offeror had to employ all of the displaced federal workers. Under those circumstances, the Army believed that it was not necessary to notify the Congress of its plans since the interests of the workers were fully protected.

In response to these events, the House National Security Committee's Military Readiness Subcommittee has placed language in Section 331 of the House DOD Authorization bill requiring Congressional notification "…regardless of whether such activities are called outsourcing, privatization, divestiture, re-engineering or restructuring [where there is a] decision to study any current defense activities for possible performance by a private contractor." The provision would also prohibit outsourcing merely for the sake of reducing headcount, and employees would e given the right to appeal solicitations and awards involving this expanded definition of outsourcing to the Secretary of Defense.

ESOPS and Other Alternatives

By its own terms, the OMB Supplemental Handbook calls for subjecting activities to cost comparison competitions only when the activities are recurring in nature. Non-recurring commercial activities are to be procured through contracts with the private sector. This language is particularly instructive as it pertains to privatization which OMB defines as follows:

> Privatization is the process of changing a public entity of enterprise to private control and ownership. It does not include determinations as to whether a support service should be obtained through public or private resources, when the Government retains full responsibility and control over the delivery of those services.

One method of privatization that is gaining attention is use of the Employee Stock Ownership Plan (ESOP) mechanism to spin-off existing government activities and employees into a new ESOP company. ESOP companies are well established with about 12,000 of them in the U.S. economy employing roughly 15 million people. Some of the more notable ones are AVIS and United Airlines. In government contractor circles, SAIC and Dyncorp are well known ESOP companies.

The ESOP mechanism is attractive to government employees who are confronted with the prospect of being subjected to an A-76 cost comparison study. It gives them the ability to take control over their own destiny, and it gives them a stake in the successful outcome of a new business. When they work, they can provide public sector employees with the fabled “soft landing” that all displaced workers covet.

ESOP transactions can be structured in a variety of ways ranging from a “standalone” approach to much more complicated arrangements that challenge even the most sophisticated merger and acquisition specialist. There are a multitude of issues to handle, and public sector employees are well advised to seek expert assistance in attempting any ESOP transaction. Fortunately, there is one relatively recent example to follow; and there are many more now in the transaction pipeline.

The precedent setting ESOP transaction involved the Office of Federal Investigations in the Office of Personnel Management (OPM). Then OPM Director James King led the effort to privatize the operation into a new ESOP company now known as US Investigations Services, Inc. (USIS). Each of the 700 USIS employees holds stock in USIS in ESOP accounts which form the primary basis for the company’s pension plan along with a traditional 401(k) plan. As USIS does well, so do the employees. The converse is also true, so the employees are motivated to see that USIS is successful and that its net worth increases.

It took a lot of hard, groundbreaking work by a variety of advisors, bankers, lawyers, and employees to see the first transaction through; and they are to be applauded for being pioneers in this area. Once the feasibility studies were completed and all were confident that USIS was a viable option, the employees selected a management team through the employees’ agent, a commercial bank acting as financial trustee.

James Dobkin, writing in the BNA article referred to above explains how the transaction unfolded:

> OPM utilized the “public interest” exemption to federal requirements for competitive procurement and awarded a sole-source contract for USIS to provide the investigative services formerly provided by federal employees. This assured the new corporation of a quantum of business to get it started. In a further effort to ease the transition and reduce the risk of a break or delay in service, the contract also allowed USIS to use government-furnished property. This allowed USIS to remain in the same offices as when it was a division of OPM and touse government-owned computers and other equipment. In exchange, USIS agreed to charge the government lower fees than what OPPM now charges other agencies for background checks.
>
> The greatest obstacle to the formation of USIS was Congress, which vehemently objected to putting arguably sensitive records in the hands of a private entity. A

> House subcommittee held hearings on the matter and several members of Congress tried to slow the transfer, questioning whether USIS would violate laws protecting privacy rights and whether local law enforcement agencies would turn over criminal records to a private company. Some even questioned whether privatization of this function would jeopardize national security. The potential security risks of transferring investigative functions from OPM to USIS were reduced by several means. As previously discussed, USIS handles only routine background investigations; it does not perform White House or Cabinet background checks. Also, DOD conducts its own investigations through an in-house entity. To further alleviate congressional concerns, OPM will maintain a small staff to make policy determinations, ensure the quality of investigations, maintain the security of the records system, and administer the contract between OPM and USIS.
>
> The OPM-USIS transfer also had to overcome arguments that it would cost the government too much money to privatize these functions. The General Accounting Office (GAO) estimated that it would cost $5.7 million to effectuate the transfer from OPM to USIS. However, GAO conceded that the government would reap significant long-term budgetary savings as a result of the privatization. These savings have been estimated to be $20 million to $25 million over the next five years. [As it turns out, the savings have proven to be far in excess of these estimates.]

Based on the USIS success story, several other governmental activities are now actively exploring the ESOP option. The key to the transaction initially is being able to define revenues and expenditure streams with sufficient precision so as to allow for the creation of a business plan. Activities that operate as enterprises with clearly defined revolving funds or reimbursable accounts are ideal candidates. Other activities with less clear revenue and expenditure streams may still be viable candidates depending upon how flexible the employees are willing to be and where new sources of revenue may be found.

In the area of Information Technology, there are clearly a number of possible privatization transactions that come to mind which could be offered to federal employees confronted with the prospect of being subjected to an A-76 cost comparison study, BRAC depot realignment or other restructuring. Indeed, the Clinger-Cohen Act actually mandates that agency heads, prior to making an investment in a new information system, determine:

1. Whether the function to be supported by the system should be performed by the private sector, and if so, whether any component of the executive agency performing that function should be converted from a governmental organization to a private organization; or

2. Whether the function should be performed by the executive agency, and if so, whether the function should be performed by a private sector source under contract or by executive agency personnel.

3. The Act requires that agency heads "…ensure that performance measures are prescribed for information technology used by or to be acquired for the executive agency, and that the performance measurements measure how well the information technology supports programs of the executive agency … where comparable processes and organizations in the public or private sectors exist, quantitatively benchmark agency process performance against such processes in terms of cost, speed, productivity, and quality of outputs and outcomes…analyze the missions of the executive agency and, based on the analysis, revise the executive agency's mission-related processes and administrative processes as appropriate before making significant investments in information technology that is to be used in support of the performance of those missions…"

   Although not mentioned explicitly as a separate step in the analysis, agency heads are implicitly required to perform a cost comparison analysis. The same issues that we have been covering come to life here as well.

In a thoughtful White Paper issued in February 1998, the General Services Administration's Deputy Associate Administrator For Information Technology, Office for Governmentwide Policy observed that there are several reasons driving Federal managers to consider outsourcing.

"These reasons can be combined and categorized as follows:

- Budget Realities
- Cost Reduction
- Access to Skilled Personnel
- Improved IT Responsiveness
- Help with Legacy Systems
- Improved Business and Customer Service
- Implement New Architecture

The Information Technology Association of America (ITAA) presented a slightly different take on the topic in its Issue Paper dated September 1997 entitled Meeting Federal IT Needs Through Outsourcing. ITAA divides the benefits derived from IT outsourcing into three general categories: technical, cost, and personnel/management. It then identifies the roadblocks to outsourcing: policy management and personnel roadblocks, cost roadblocks, and process roadblocks. The language concerning cost is particular interesting:

> The financial roadblocks to outsourcing are the direct results of the federal appropriations and contracting processes. Contractors are wary of he federal appropriations process, and with good reason. If a program for which a company has a contract is not fully appropriated by future Congresses, the company and the agency are in a very difficult position. Long-term business planning is therefore problematic in the federal market, and this is made even more troublesome in outsourcing contracts, given the typical long time frames involved in federal outsourcing. Although outsourcing timelines in the private sector average a little more than a year, the Defense Department, as just one example, averages more than two and a half years from presolicitation to implementation.
>
> These funding roadblocks are partially related to the process roadblocks to outsourcing, because of the nature of federal contracting. Even if an agency has fully considered the outsourced option, there are still significant process obstacles that need to be addressed before an outsourcing decision can be implemented. There are statutory and regulatory restriction limiting the types of work that can be outsourced; the question of defining a specific task as "inherently governmental" under OMB regulations requires careful study. Also, there are information costs on both sides of the outsourcing equation for

> government and contractors. Each party has difficulty gathering and analyzing enough information about agency processes and cost data to provide the capability for a sophisticated outsourcing solution. Although the creation of Chief Information Officers in agencies is a step in the right direction, the ultimate effectiveness of this reform remains to be seen, particularly since CIOs do not have full control over the actual program dollars that would pay for an outsourcing solution.

These are difficult problems, but they lend themselves to innovative approaches. An ESOP makes sense under certain circumstances, especially when an agency decides it no longer is interested in keeping the equipment or people that historically handled the agency's IT function. Once that decision is made, or the idea of outsourcing IT comes into play, then it makes sense to examine what is happening in the commercial IT arena for best practices baselining purposes. In this regard, Anthony DiRomualdo and Vijay Gurbaxani wrote a paper entitled Strategic Intent for IT Outsourcing which appeared in the Summer 1998 edition of the Sloan Management Review. In it , the authors noted that there are three kinds of "strategic intent" that motivate outsourcing decisions. They are:

1. Reducing costs and enhancing efficiency,

2. Outsourcing for business impact by focusing on improving IT's contribution to company performance within its existing lines of business, and

3. Commercial exploitation which focuses on leveraging technology related assets – applications, operations, infrastructure, and know-how – in the marketplace through the development and marketing of new technology-based products and services.

This translates into three different but related objectives: IT cost reduction and service improvement, improved business performance, and creation of commercial ventures. It is this latter category that bears examination in he context of the new ESOP movement.

In exploring creating a "commercial exploitation" new venture, it is important, as a good starting point, to examine the overall process into which the IT equipment and people fit. The goal is to examine the overall context in which the IT services are provided. This necessarily takes us into a business process analysis. The authors note:

> Many organizations must simultaneously create a new IT capability – the new systems, re-engineered work practices, reskilled staff, and entrepreneurial culture – to compete in the emerging digital world while maintaining (and improving) the status quo. Our research strongly suggests that this is very difficult for [IT] groups to do on their own. Most lack the necessary skills, and

> financial resources. Outsourcing can free up financial resources and management attention, support the operation and maintenance of existing systems until they can be replaced, provide career paths for staff with legacy skills, and supply technical and business know-how to augment initiatives.
>
> Furthermore, few [IT] organizations have the capabilities to exploit IT in the marketplace: the know-how to commercialize and sell IT products and services originally developed by a single company, the ability to establish new distribution channels for IT-based products and services, the skill to port systems to various technology platforms, and the wherewithal to support and enhance products and services after they are sold.

The authors cite numerous recent examples of how companies have recently set up new commercial ventures in developing and marketing new IT-based products and services jointly with outsourcing partners including Hyatt Hotels, Lufthansa, Ryder Systems, Ameritech, Swiss Bank Corporation, Delta, AT&T, IBM, CSC, N.V. Philips, and the Public Service Company of Colorado. These new joint ventures take many different business and legal forms; but they have in common the key ingredient of adequate incentives for each party to share costs and risks over the course of the relationship:

> Given the uncertainty in the level of required investments and the underlying risk and potential payoffs, it is difficult, if not impossible, to write a contract that specifies each party's commitments for the future. Accordingly, relationships should be built around strategic alliances, joint ventures, and joint ownership arrangements that align incentives at the level of business outcomes. In managing the relationship with the outsourcing vendor, companies should focus performance metrics on results such as increased return on assets, ration of IT spending to recovered costs, new revenues, net profits, gains in market share, launch rate of new products and services, and development of new businesses and market share.

Any IT ESOP company that spins away from the public sector will face competitors in the marketplace built around these new models. Hence, in examining all alternatives under the Clinger-Cohen Act, it is incumbent on those doing the analysis to give serious consideration to the mechanics and strategy associated with commercial exploitation initiatives.

STEPHEN M. SORETT

Mr. Stephen Sorett is a senior manager in the Washington, D.C. area office, specializing in all phases of government contracting with an emphasis on acquisition transactions including contract formation, administration, claims, and audit resolution. Mr. Sorett is also active as the practice leader of the government contracts group in the areas of contract reform, privatization, electronic commerce and reengineering business strategies. Mr. Sorett has over 25 years of acquisition experience in all phases of government contracting and is recognized as one of the nation's leading experts in the field of public contracts, privatization, outsourcing and alternative service delivery. He has actively participated in over 200 such projects covering wastewater treatment works, drinking water systems, resource recovery plants, light rail and intermodal transportation projects, correctional facilities, medical systems, educational services, and municipal buildings. At the federal level, Mr. Sorett served as Chairman of seven national conferences - Federal Privatization - hosted by the National Council for Public-Private Partnerships - an organization co-founded by Mr. Sorett in 1985 - and supported by Vice President Gore's National Performance Review. In addition, Mr. Sorett teaches the course on OMB Circular A-76 at the George Washington University's Law School; and he chaired the 1998 National Conference on OMB Circular A-76.

Steve last served as the Director of Curriculum for the Government Contracts and Environmental Law Programs at the George Washington University's National Law Center where he administered all continuing legal education courses for both programs. He also organized major conferences and special projects dealing with current issues such as procurement reform, implementation of FASA, environmental liabilities, and privatization. Prior to this, Steve was Vice President and Assistant General Counsel for Special Compliance Matters at ICF Kaiser International, Inc., a major environmental and consulting company, where he was responsible for contract pricing, contract administration, audit liaison, and compliance with government contract legal and regulatory matters. He also handled bid protests, claims, contested audits, and mergers and acquisitions. Steve also was Legal Director and Assistant Secretary at AAI Corporation, an aerospace and defense firm, where he supervised litigation, intellectual property, licensing, leases, and government contract matters, including bid protests, claims, and disputes. Earlier in his career, he served as a manager at Touche Ross & Co. where he served as a consultant to government contracting professionals dealing with cost and accounting issues. He also served as a senior attorney at the U.S. Environmental Protection Agency and a staff attorney at the U.S. General Accounting Office.

RELEVENT EXPERIENCE

Grant Thornton LLP (1995 – Present)

Director Of Government Contract Services

Responsible for managing Privatization and Government Contract Services group including cost and pricing matters, claims, contested audits, and advice on compliance with federal laws, regulations, policies, and guidelines including cost principles, cost accounting standards and general procurement issues including OMB Circular A-76, outsourcing, managed competition, and cost comparison methodologies.

Recent projects include*:*

- Consulting to the District of Columbia Government on Privatization including the Correctional Treatment Facility, the Police and Fire Clinic, the Oak Hill Youth Academy, and an ESOP composed of doctors and nurses employed by the District. Led team that studied and implemented some of the most challenging privatization and outsourcing efforts for the District.
- Training on the new OMB Circular A-76 for George Washington University Training and consulting on Federal Privatization
- Past Performance Survey of Government and Industry Procurement Officials
- Analysis of Electronic Commerce Trends and Acquisition Reform-Advising clients on CAS/FAR compliance matters
- Training and consulting on "commercial" products and services
- Host of Grant Thornton "Roundtables" and "Whitepapers"

The National Law Center, George Washington University (1994 – 1995)
Director, Government Contract And Environmental Law Programs

Responsible for all facets of the Government Contracts and Environmental Law continuing legal education program including seminars, publications, research on-site presentations, and maintaining the high quality of faculty associated with the program. Worked closely with GWU Lay School faculty, including Ralph Nash and John Cibinic and adjunct lecturers from major law and accounting firms in developing and updating courses and curriculum. Curriculum consisted of over 50 courses and several national conferences covering a full spectrum of legal topics in the fields of government contracts and environmental law including the GWU/BNA Annual Government Contracts Symposium and three national conferences on Federal Privatization.

ICF Kaiser International, Inc. (1993 – 1994)
Vice President, Contracts and Assistant General Counsel, Special Compliance Matters

Supervised and managed the Contracts Department for this major environmental consulting and construction engineering firm. Responsibilities included contract pricing, administration and audit liaison with the Defense Contract Audit Agency and the EPA Office of Inspector General. Ensured compliance with all government contract legal and regulatory matters, including costs and ethics compliance. Handled all communication between government audit and investigative agencies and the company. Handled bid protests, claims, contested audits and mergers and acquisitions on behalf of company. Coordinate outside counsel activities. Served on project finance, technology, and marketing and sales committees.

AAI Corporation (1986 – 1993)
Legal Director and Assistant Secretary

Supervised and managed legal department for this major engineering and manufacturing company with annual revenues of $250 million. Responsibilities included handling all litigation, intellectual property protection, licensing, leases and all government contract matters including bid protests, claims and disputes. Handled legal issues pertaining to human resources, environmental claims and compliance, and mergers and acquisitions. Provided legal counsel to President and senior executives on a regular basis.

Significant accomplishments include winning several multi-million dollar judgements involving litigation against the Government and other companies; standardizing the way the company handled intellectual property protection including invention disclosures, patent applications, nondisclosure and teaming agreements, and subcontractor agreements; and structuring several international transactions involving transportation technology in the company's efforts to diversify from its predominately defense oriented business base.

Touche Ross & Co. (1983 – 1986)
Manager

Served as in-house counsel to government contract practitioners dealing with government contract cost and accounting issues such as cost accounting standards, cost principles, contested audits, claims and appeals. Worked closely with former Executive Director of the Cost Accounting Standards Board, on CAS and FAR matters for major government contractor clients. Also served as National Coordinator for Privatization and Infrastructure Finance in providing project finance advisory services to clients in environmental and infrastructure markets. Consulted on over 100 privatization projects, mostly with state and local governments; and was one of the founders of the Privatization Council (now the National Council on Public-Private Partnerships) in 1984.

U.S. Environmental Protection Agency (1980 – 1983)
Senior Attorney

Lead EPA attorney responsible for overseeing spending of grant funds under construction grants program for publicly owned wastewater treatment works and Superfund actions. Author of procurement under grant and cooperative agreement regulations, 40 C.F.R. Parts 30, 32 and 33. Author of EPA's unified Suspension and Debarment Regulations. Helped to establish financial and contractual structure of Superfund program and provided legal advice to key EPA officials during program's first three years. Administered national bid protest and claims under assistance agreements process. Served as project coordinator to American Bar Association's Model Procurement Code and Ordinance initiatives. Served as special counsel to EPA's Inspector

General dealing with fraud, waste, abuse, as well as criminal matters occurring under EPA programs.

U.S. General Accounting Office (1976 – 1980)
Attorney

Handled bid protest cases including acting as hearing officer at conferences and writing decisions. Dealt with all aspects of civilian and military acquisition, appropriations law and personnel law, and legal issues arising from GAO audit reports. Provided counsel on draft legislation and regularly conducted research into legislation and policies affecting procurement law.

AFFILIATIONS

Member of the Bars of the State of Maryland and the District of Columbia
Member of the American Bar Association
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National Contract Management Association
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EDUCATION

B.A., Yale University
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LEGAL ACTIVITIES

Member, Procurement Committee of National Security Industrial Association
Member, Professional Services Council,
American Bar Association's Public Contract Law Section, Chair and Vice-Chair of several committees.
Director and Co-Founder of the National Council for Public-Private Partnerships (formerly The Privatization Council)
Professorial Lecturer, Kigod College of Business Administration (The American University), 1984-1986
Chairman, Federal Grant Law Committee of the Federal Bar Association's council of Government Contracts from 1979-1983.

BAR MEMBERSHIPS

Member of the Bars of the State of Maryland, the District of Columbia, the U.S. Court of Federal Claims, the U.S. District Court for the District of Columbia, the U.S. District Court for the district of Maryland, and the U.S. Supreme Court