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### FEATURE COMMENT: Defining Cost Or Pricing Data

The Air Force recently announced its view of the definition of cost or pricing data in two highly unusual, and widely publicized, notices that grew out of a *qui tam* case filed in the Western District of Texas, *U.S. ex rel. Woodlee v. Science Applications Int'l Corp.* This FEATURE COMMENT analyzes the Air Force's interpretation and concludes that it is unsupported by either the Truth in Negotiations Act or cases defining cost or pricing data.

**Litigation Positions in the Guise of Policy**—The first and most sensational of the two notices was issued on December 20, 2004, by the director, Office of Fraud Remedies, Office of the General Counsel (SAF/GCR). Captioned "False Claims Alert re Science Applications International Corporation ("SAIC")" in large, bold-face type, the alert announced that the U.S. had intervened in the *Woodlee* *qui tam* case, and then proceeded to summarize the allegations in the complaint. According to the alert, in preparing price proposals for fixed-price contracts, SAIC performed an internal Quantitative Risk Analysis (QRA) to consider "possible business risks that SAIC might encounter, such as internal inefficiencies, inoperable equipment, or unanticipated schedule delays." SAIC then added variance labor hours to cover the estimated costs of these risk factors. In submitting its proposed labor hours, which the alert erroneously called "part of SAIC's cost and pricing data," SAIC did not disclose the risk factors, the QRA or that the proposed labor hours included a risk reserve. Con-

sequently, the alert concluded, SAIC estimated (and ultimately achieved) higher profit margins than proposed to the Air Force. The alert asserted that by failing to disclose the QRA and resulting variance hours, "SAIC has violated the Truth in Negotiations Act, 10 U.S.C. § 2306a, and the False Claims Act, 31 U.S.C. § 3729, et seq." Moreover, the alert stated, "SAIC has told the Department of Justice that it intends to continue using Quantitative Risk Analysis and variance hours *without disclosing those elements to the Air Force.*" The alert encouraged recipients to "disseminate this bulletin as widely as possible to contracting officers, contract negotiators and contract offices throughout the Air Force." In fact, the alert was distributed throughout the Department of Defense and to some civilian agencies, as well as to prime contractors that have subcontracts with SAIC.

The Air Force followed up with a slightly less sensational, but equally erroneous, "Defective Pricing Notice" issued on February 11, 2005. Quoting from FAR Table 15-2 Instructions, the notice asserted that contractors are required to submit with their proposals "any information reasonably required to explain your estimating process, including—(1) The judgmental factors applied and the mathematical or other methods used in the estimate, including those used in projecting from known data; and (2) The nature and amount of any contingencies included in the proposed price."

Although allegations in a complaint are legally protected regardless of their truth or falsity, there is no privilege, much less justification, for widely circulating those allegations throughout the defense industry. The Air Force exhibited poor judgment and appalling business practices in gratuitously besmirching the reputation of one of its major contractors. Wholly apart from the poor choice of vehicles for communicating this policy, the policy itself is flawed.

**Estimates and Risk Reserves Are Not Cost or Pricing Data**—Contrary to the position espoused in the Air Force's notices, a contractor's judgmental risk assessment is not cost or pricing data. Nor do the Table 15-2 Instructions define "cost or pricing data." "Cost or pricing data" is defined by statute, and the definition spe-

cifically states that it “does not include information that is judgmental, but does include the factual information from which a judgment was derived.” 10 USCA § 2306a(h)(1). FAR 2.101 expands on the statutory definition by explaining that:

Cost or pricing data are factual, not judgmental; and are verifiable. While they do not indicate the accuracy of the prospective contractor’s judgment about estimated future costs or projections, they do include the data forming the basis of that judgment. Cost or pricing data are more than historical accounting data; they are all the facts that can be reasonably expected to contribute to the soundness of estimates of future costs and to the validity of determinations of costs already incurred.

A risk assessment is nothing more than the contractor’s judgment of future risks; it is not verifiable, and cannot be certified as accurate, complete and current. While facts contained in the risk assessment, on which the risk assessment is based and that can be reasonably expected to contribute to the soundness of the risk assessment, are all cost or pricing data, neither the risk assessment itself nor the fact that it exists is cost or pricing data. The statutory definition distinguishes between “information that is judgmental” and “factual information from which a judgment was derived.” The fact of judgment, or fact that an estimate exists, is plainly not information from which the judgment or estimate was derived. Indeed, if the fact of an estimate were cost or pricing data, the exception would swallow the rule.

Three decisions by the Armed Services Board of Contract Appeals may help illustrate the important distinction between facts and judgment. In *Texas Instruments, Inc.*, ASBCA No. 23678, 87-3 BCA ¶ 20,195, the board held that a computer-generated estimating report that contained both verifiable facts, in the form of historical costs, and elements of judgment, in the selection of the historical data included in the estimate, was cost or pricing data that must be disclosed. Importantly, however, the report in that case was disclosed, and the issue before the ASBCA was whether the report was defective. As to that issue, the ASBCA held that the report was “accurate, complete, and current with respect to what it represents.” Put another way, the report was an estimate, and it did not purport to be anything more.

*Litton Sys., Inc., Amecom Div.*, ASBCA No. 36509, 92-2 BCA ¶ 24,842, involved a contractor’s failure to disclose its “Estimated Standard Labor Hour” (ESLH) reports. The reports contained “standard labor hours,” which were derived from estimates by the contractor’s industrial engineers of how many hours it should take to perform each production operation in fabricating and assembling a particular part. To that raw estimate, the industrial engineer added a personal fatigue and delay frequency factor of 13 percent. The reports also contained standards for product test labor, which were estimated by the contractor’s test engineers. The ASBCA distinguished *Texas Instruments*, observing that the report at issue in *Texas Instruments* contained “mixed fact and judgment,” whereas the ESLH reports were not mixed fact and judgment and contained no “underlying document that is verifiable.” Accordingly, because the ESLH reports were “pure judgment,” the ASBCA held that they were not cost or pricing data and need not be disclosed. Significantly, neither the facts of the reports, which were generated in the ordinary course of the contractor’s business and used in estimating material costs, the standard labor hours, nor the personal fatigue and delay frequency factor was found to be cost or pricing data.

*Black River Ltd. Partnership*, ASBCA No. 46790, 97-2 BCA ¶ 29,077, involved a competitively awarded, long-term contract to build a contractor-owned contractor-operated production plant to provide High Temperature Water (HTW) at Fort Drum. The Government realized that due to the size of the project, third-party financing would be necessary. After the contract was negotiated but before the award was effective, Congress enacted the Tax Reform Act. Recognizing that the new law would affect the contractor’s rate of return, the parties included in the contract a tax adjustment clause requiring an adjustment in the monthly HTW rate. The clause was intended to preserve the contractor’s rate of return as of its best and final offer (BAFO). In its post-award proposal for an equitable adjustment, the contractor provided pro formas purporting to represent its “as bid” and current rate of return. A pro forma is a computerized pricing model that records certain business assumptions, and, based on those assumptions, reflects an expected cash flow. However, while the contractor’s actual BAFO pro forma had a rate of return of 15

percent, the “as bid” pro forma submitted with the contractor’s proposal and used in negotiating the equitable adjustment had a rate of 33.3 percent. On those unusual facts, the ASBCA held that the pro formas were cost or pricing data. A pro forma, just as the ESLH reports in *Litton Sys.*, is “pure judgment” and reflects the contractor’s estimated rate of return. However, because the tax adjustment clause was intended to preserve the contractor’s expected rate return as of the BAFO, the contractor’s BAFO and current estimated rates of return were verifiable facts for purposes of pricing the adjustment.

**The Contractor’s Proposal Is Not Cost or Pricing Data**—In accusing SAIC of using “hidden ‘risk reserves’ to inflate its costs proposals,” the Air Force’s notices inaccurately characterize SAIC’s proposed labor hours as cost or pricing data. As the ASBCA recently reaffirmed in *United Technologies Corp.*, ASBCA Nos. 51410 et al., 04-1 BCA ¶ 32,556; 47 GC ¶ 86, a contractor’s proposal is not cost or pricing data. Nor does the Truth in Negotiations Act require that a contractor *use* its cost or pricing data in preparing its proposal. To illustrate the point, assume that performance of a particular task has historically required an average of 100 labor hours. Assume further that for a variety of risk-related reasons, the contractor estimates that it may require 120 hours to perform the task. Provided the contractor discloses all of the facts on which its estimate is based, or that can be reasonably expected to contribute to the soundness of its estimate, and makes no inaccurate representation about what its proposal represents, there is nothing wrong with proposing 120 labor hours. Moreover, because the risk assessment is pure judgment, the contractor need not disclose it.

The Air Force’s notices are similarly mistaken in their assumption that it is defective pricing if a contractor estimates higher profit margins than those proposed. In addition to the fact that the contractor’s proposal is not cost or pricing data, the parties do not negotiate a profit margin for a fixed-price contract. In an analogous case, the Court of Federal Claims held that the contractor was not entitled to reimbursement for state income tax payments under its negotiated fixed-price contracts because even if the CO, in negotiating the contract’s fixed price, erroneously believed the costs were unallowable, not every allowable cost must be specifi-

cally represented. *Information Sys. & Networks Corp. v. U.S.*, 2005 WL 741855 (Fed. Cl. Mar. 31, 2005); 47 GC ¶ 177. The court stated that:

Unlike cost-reimbursement contracts, the focus of a fixed-price negotiation is on total price, rather than individual costs. While a fixed-price negotiation may rely on cost principles to establish a frame of reference for negotiating the overall price, the goal of the negotiation is not to remunerate the contractor for each individual allowable cost. Instead, the goal is to reach a “fair and reasonable” price based upon the universe of costs.

Id. at 8. Because fixed-price contracts are negotiated on the basis of total price, they do not contain a negotiated profit margin.

**Let DOJ Litigate and the FAR Councils Define Policy**—For all of these reasons, the “policy” articulated in the Air Force’s defective pricing notices is wrong. If the notices were influenced by the Department of Justice attorneys responsible for the *qui tam* litigation, they are doubly wrong. DOJ is authorized to litigate on behalf of the Federal Government, not to define its acquisition policy.



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