

Legal News

Contracting out

GAO Says Navy Unduly Delayed in Taking Corrective Action in A-76 Protest

The Navy's undue delay in taking corrective action following a clearly meritorious protest of a cost comparison has prompted the General Accounting Office to recommend that the protester be reimbursed its protest costs (The Jones/Hill Joint Venture-Costs, GAO, B-286194.3, 3/27/01 [redacted decision released 4/10/01]).

An agency cannot ignore the strengths identified by its own evaluators, GAO stressed in a March 27 decision that was released April 10. GAO cited Rice Services Ltd., B-284997 (2000), which found that an agency apparently had set aside the strengths identified in a private sector proposal without any reasonable basis (73 FCR 389; 74 FCR 92).

In view of Rice Services, it should be clear that a protest would be clearly meritorious if it established that the agency had identified strengths in a private sector proposal but then failed to consider them in the comparison with the government's most efficient organization (MEO), GAO said. "Because that was what happened here, we view [the] protest as clearly meritorious."

Accordingly, GAO recommended that protester Jones/Hill Joint Venture be reimbursed its costs in challenging the Navy's determination that it was more economical to perform certain base operations and support services in-house rather than by contracting out.

Jones/Hill Won Private-Private Competition. In May 1999, the Navy issued a solicitation for base operations and support services at the Naval Air Station, Lemoore, Calif. The procurement was conducted under Office of Management and Budget Circular A-76 cost comparison procedures.

The private sector offerors would compete, and the best value offer would be selected. That offer, in turn, would be compared to the government's in-house proposal to determine if contractor or in-house performance was more economical to the government.

Jones/Hill won the private sector competition. A Navy quality comparison panel then analyzed the proposals to ensure that the MEO and Jones/Hill's proposal offered the same level of performance and performance quality.

In conducting its cost comparison, the Navy added a conversion differential to Jones/Hill's proposed price. Since the MEO's proposed costs were lower-the GAO decision does not say by how much-the Navy decided to perform the work in-house. Jones/Hill filed an agency-level appeal.

The appeal was unsuccessful, prompting Jones/Hill's protest to GAO. The joint venture challenged the ad-

equacy of the comparison of in-house versus contractor performance. It also contended that the Navy failed to inform offerors of certain changed requirements, as well as an inter-service support agreement with the General Services Administration.

After Jones/Hill submitted its comments to the agency report, the GAO attorney asked the Navy to respond in more detail concerning the assessment of in-house versus contractor performance and quality, and the lack of notice of the inter-service agreement. The Navy provided the supplemental report as GAO requested.

The Navy requested that GAO use alternative dispute resolution to attempt to resolve the matter. GAO conducted an ADR conference, and told the parties that the Navy "faced significant litigation risk" concerning the determination of performance and performance quality and the failure to disclose the inter-service agreement.

Protest Dismissed: Navy Promises Corrective Action. The Navy agreed to take corrective action. The quality panel would reexamine the strengths of the Jones/Hill proposal and adjust the MEO proposal to account for those strengths. In addition, the agency said it would review the approaches to maintenance and repair, as discussed during the ADR proceedings.

Accordingly, GAO dismissed the protest as academic.

Jones/Hill then requested reimbursement of its protest costs. It said the Navy unduly delayed taking corrective actions in response to a clearly meritorious protest.

GAO: Protest Was Clearly Meritorious. The Navy contended that guidelines for Circular A-76 cost comparisons are "murky at best," and that Jones/Hill's protest was not clearly meritorious.

The A-76 Supplemental Handbook provides that when a best value approach is used in evaluating private sector proposals, the agency must compare the MEO proposal to the private sector proposal to determine whether the same level of performance and quality will be achieved, GAO observed. "This 'leveling of the playing field' is necessary because a best value solicitation invites submission of proposals that exceed the RFP requirements, together with the higher prices that often accompany a technically superior approach."

The Navy's value assessment team identified 68 strengths in Jones/Hill's proposal during the private sector best value competition. However, these strengths were not considered by the quality panel in determining that the MEO would provide the same level of perfor-

mance and performance quality as Jones/Hill. "Because the agency failed to consider those strengths. . . or in the alternative, reasonably explain why these strengths were not considered, this aspect of Jones/Hill's protest was clearly meritorious," GAO found.

Even when the quality panel gave some consideration of the level of performance and performance quality offered by Jones/Hill, the Navy accepted-based on unsupported assumptions and without adequate analysis-claims by the MEO regarding its ability to achieve the same level of performance and quality, GAO said. "Failure to perform an adequate analysis in this regard can result in giving one side. . . an unfair competitive advantage, because it is unreasonably freed of the cost burden associated with the other side's higher level of performance."

GAO concluded:

"Thus, we regard Jones/Hill's protest as clearly meritorious, and find that the agency unduly delayed taking corrective action in response to the protest, given that it did not do so until after the submission of an agency report, the protester's comments, a supplemental agency report, supplemental comments, and an alternative dispute resolution conference. . ."

Jones/Hill was represented by William A. Roberts, Philip H. Harrington, William S. Lieth, and Janet L. Eichers of Wiley, Rein & Fielding, Washington, D.C.

Taxation

Government's Share of State Tax Refund Is Based on Hercules' Contract Mix at Outset

The federal government's share of a \$10.5 million state tax refund received by Hercules Inc. must be determined based on Hercules' mix of federal contracts when the tax was imposed, not when it received the refund, the U.S. Court of Federal Claims ruled March 27 (*Hercules Inc. v. United States*, Fed. Cl., No. 98-127C, 3/27/02).

The court said its 1978 decision in *Grumman Corp. v. United States* controls here, despite the subsequent adoption of the Cost Accounting Standards and Hercules' consistent practice under CAS of including state tax refunds as part of the tax costs of the year in which the refund was received.

"[T]he teaching of *Grumman*, namely, that if the Government pays a cost of a contractor and . . . later that contractor receives a credit or refund of that cost, the Government receives the benefit of that reduction, in proportion to how that cost was initially calculated, is applicable to contracts governed by the CAS," Judge Edward J. Damich said.

Attorneys and accountants familiar with the decision say Hercules' practice with regard to accounting for tax refunds is not an uncommon one, and that an appeal of the decision is likely.

CAS 406, 410 Impose No Specific Requirements. Hercules argued that it followed a consistent practice of including refunds of state income taxes as part of the tax costs of the year in which the refund was received, and, accordingly, that under CAS 406 and CAS 410, the government's share of the state tax refund should be calculated on the basis of the contract mix in effect when the refund was received.

Hercules' argument assumes that a tax refund is an indirect cost, the court said. "It is not. A tax refund is a credit for a previously recognized and allocated indirect tax cost."

The court acknowledged that CAS 406 requires that contractors follow a consistent practice in selecting a period to accumulate and allocate adjustments, including prior period adjustments. It also acknowledged that CAS 410 requires that a general and administrative expense be allocated to the cost of the period for which it was entered. However, CAS 410 does not impose a specific requirement as to how credits for G&A expenses will be allocated and CAS 406 does not state that a credit to an expense of a prior period must be allocated to the year in which the credit was received, the court emphasized.

"The absence of such a requirement in the CAS is sensible because if a tax refund were treated as a separately allocable cost that had to be allocated according to the allocation base of the year in which the refund was received, there would be no nexus between the cost and the credit relating to that cost," the court observed.

Further, such a requirement would conflict with the Federal Acquisition Regulation, under which a tax credit is treated as a reduction of a pre-existing cost, but not as a cost itself, the court said.

Court Declines to Apply Litton Systems Rule. Citing considerations of "fairness, reasonableness, and equity," the court declined to apply the rule against retroactive cost accounting changes it announced in *Litton Systems Inc. v. United States*, 196 Ct Cl. 133 (1971). The Litton Systems rule is that the government cannot force a contractor to make a retroactive change of an incorrect cost allocation method if: (a) the contractor has had "a long and consistent use" of the allocation method in question, and (b) the contractor was "unduly prejudiced" by failing to receive reasonably adequate notice that the government would no longer approve of that method.

Even if Hercules had a consistent practice of calculating credits with an allocation base reflecting the year in which the credit or refund was received, fairness, reasonableness, and equity favor the government, the court said.

For one thing, such an allocation method is not reasonable, the court said, because "to calculate the original tax cost according to one standard and then calculate a credit of that cost using a different standard leads to results that are entirely fortuitous." Here, Hercules would receive a windfall by applying the mix in effect the year it received the refund, but given the contingent nature of future business relationships with the government, it would be equally possible that Hercules could be short-changed if that mix pointed in the opposite direction, the court observed.

Further, Hercules cannot claim unfair prejudice because the contractor itself represented to the Justice Department in 1992 that it would use the year the tax was imposed in calculating the government's credit for any state tax refund it received.

Prior litigation on Allowability of Tax. Hercules made that representation in the context of earlier litigation-Hercules I-regarding whether the state tax paid on a gain realized from the sale of wholly commercial assets was an allowable cost allocable to its federal contracts.