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February 28, 2005

Mr. Terry Hallberg
Chief
Program Analysis and Monitoring Branch
Food and Nutrition Service
United States Department of Agriculture
3101 Park Center Drive, Room 460
Alexandria, VA 22302-1594

Re: CND Proposed Procurement Rule

Dear Mr. Hallberg:

Compass Group USA, Inc. d/b/a Chartwells ("Chartwells") appreciates the opportunity to submit the following comments on the notice of proposed rulemaking entitled "Procurement Requirements for the National School Lunch, School Breakfast and Special Milk Programs" in the December 30, 2004 Federal Register (69 FR 78340). Chartwells provides food service to 516 school food authorities ("SFAs") throughout the United States. Chartwells is the only one of the three major food service management companies ("FSMCs") with a dedicated sector that provides food service to K-12 students. While the SFAs are in the business of educating children, Chartwells is in the business of providing them with carefully planned and well-balanced meals.

Chartwells is owned by Compass Group, a global foodservice company headquartered in the United Kingdom with approximately 450,000 employees worldwide. Compass Group, USA, Inc, is headquartered in Charlotte, North Carolina, and operates a wide variety of foodservice businesses across the country, in institutional (i.e. businesses, healthcare, schools) and retail settings, with over 117,000 U.S. based employees.

As a result of its purchasing power and its commitment to providing affordable, nutrition meals, Chartwells has consistently enabled SFAs to deliver nutritious and appealing meals at a lower cost than SFAs that operate their own food service. Further, by providing food service management to

SFAs, Chartwells enables educators to focus their resources on the area in which they have expertise – educating children.

Chartwells appreciates the significant amount of effort the Food and Nutrition Service has devoted to drafting regulations to address procurement issues and assure that food service management companies are provided a level playing field. As noted below, however, we believe that the objectives of promoting transparency and free and open competition would be better served by a different regulatory approach.

The portion of the rule that Chartwells believes should be revisited is the proposed amendment of 7 CFR 210.21(a)(3) and 210.21(e), set forth at 69 FR 78348, which states that in all contracts with cost reimbursable provisions, costs must be net of all discounts, rebates or credits.[1] The rule also requires that contractors individually identify discounts, rebates and credits on bills and invoices, and provide documentation to school food authorities.

1. <u>The proposed rule is inconsistent with existing procurement guidelines and regulations</u>.

   Schools already benefit from credits/discounts/rebates because they enable food service management companies to offer lower administrative and management fees than SFAs might otherwise receive, and thus reduce the cost of food service to the SFAs. FSMCs are able to offer markedly lower prices to SFAs because of their overall corporate purchasing power. This is a noteworthy point because all clients, including the SFAs, benefit directly from this national purchasing power in the form of lower food and product costs. The proposed rule would disincentivize economies of scale and create a procurement system that is not as efficient as it could be.

   Further, it must be noted that FSMCs devote substantial resources to negotiation and management of purchasing programs in which suppliers agree to provide discounts and rebates. If FSMCs are prohibited from applying rebates and discounts to internal costs, as permitted under existing guidelines, they will lose the incentive they currently have to take advantage of economies of scale and negotiate and administer purchasing programs containing rebates and discounts. This may lead FSMCs to refrain from negotiating such arrangements. This is particularly true with respect to products that are sold only or principally in schools. That is, if an FSMC is negotiating rebates or discounts with a supplier that provides a variety of products, the FSMC is likely to focus its negotiations on those products where it will derive the greatest benefits, not where those benefits have to be passed forward to the SFAs. As a result, not only will management and administrative fees increase for the reasons set forth above, but food costs will also increase. Thus, the proposed rule is a disincentive to efficient purchasing programs that presently benefit SFAs.

[1] Identical language is also included in proposed amendments to 7 CFR Parts 215 and 220, and thus these comments also apply to the proposed amendments to those CFR sections.

Not only do credits/discounts/rebates help to reduce the cost of food service, but the current regulatory framework for procurement permits FSMCs to apply credits/discounts/rebates they collect as a credit against their allowable indirect costs. This principle applies under cost principles contained in applicable Federal Acquisition Regulations ("FAR"), as well as under the OMB Circulars cited in the proposed rule

The FAR, at 48 CFR Subpart 31.2, provides that FSMCs are allowed to retain negotiated credits/discounts/rebates as a credit toward the indirect costs it incurs in providing NSLP food services. The proposed rule (see 69 FR at pp. 78340 and 78342) states that the OMB Circular applies, thus implying that FAR is inapplicable. Notwithstanding the statement contained in the proposed rulemaking, the FAR regulations are applicable because 7 CFR § 3015.194, which directs the USDA to comply with 7 CFR Part 3015, states that "[t]he principles to be used when determining the allowable costs of activities . . . are contained in the [FAR] at 48 CFR Subpart 31.2." The FAR Regulations at 48 CFR § 31.2 state: "Costs of material shall be adjusted for income and other credits, including trade discounts, refunds, rebates . . [but] such income and credits shall either be credited directly to the cost of the material **<u>or</u>** be allocated as a credit to the indirect costs." FSMCs spend significant sums of money pursuing, negotiating, accounting for, and tracking various credits/discounts/rebates. Ultimately, the SFAs benefit from these efforts by paying less for nutritious meals. The FAR simply allows FSMCs to allocate any credits/discounts/rebates against any indirect costs incurred in obtaining these funds.

Assuming strictly arguendo that FAR does not apply and that OMB Circular A-87 governs, a review of Circular A-87 demonstrates that it supports the same principle as the FAR. Circular A-87 provides, at Section C, paragraph 4(a) thereof, that "[a]pplicable credits refer to those receipts or reduction of expenditure-type transactions that offset or reduce expense items allocable to Federal awards as direct or indirect costs." At Section D, paragraph 1 of Circular A-87, it states that "[t]he total cost of Federal awards is comprised of the allowable direct cost of the program, plus its allocable portion of allowable indirect costs, less applicable credits."

Whether the FAR or Circular A-87 applies, SFAs receive the benefit of the company's purchasing power because the discounts obtained result in lower prices and costs for the SFAs, i.e., a lower cost of administration the SFAs' contracts.

2. <u>If the goal of the Food and Nutrition Service is to create a level playing field among FSMCs, this goal would be better served by transitioning contract food service to a fixed price basis</u>.

In addition to the regulations imposed by the USDA, school nutrition programs operate in accordance with state regulations. In at least two states (New York and Illinois), state agencies have directed that contracted food service be awarded strictly on a fixed price basis in which the FSMC provides meals at a fixed price inclusive of food, overhead and profit. Cost recovery principles such as those contained in the regulations and OMB Circulars are irrelevant to such contracts, and SFAs have the ability to easily compare one bid against another with the confidence that only a single cost variable – the fixed price – is at issue. Chartwells submits that if the USDA's goal is to place all FSMCs on a level playing field, the most efficient way

to do so would be to require that all food service management contracts be awarded on a fixed price basis.

In this regard, USDA should analyze the effectiveness of the various means of providing school food service, i.e. traditional and FSMC, under various types of contracts and RFPs, to assess which approach provides schools and students with the best quality, lowest cost meals. Rigid compliance with perceived accounting requirements should not be elevated above providing better meals at lower prices, which FSMCs provide.

3. If the rulemaking is adopted, it should be modified to clarify FSMCs' ability to recover costs associated with procurement.

   FSMCs incur substantial costs in administering procurement programs, including the costs of selecting suppliers, negotiating contractual terms, monitoring supplier compliance, and performance of payment and accounting functions. The proposed rulemaking leaves unresolved the question of how FSMCs are to be compensated for such efforts.

   Certain state agencies, such as those in Rhode Island and Minnesota, currently require that discounts/credits/rebates be credited to SFAs, but permit FSMCs to charge a procurement fee. In submitting bids in response to RFPs, FSMCs set forth the estimated amount the SFA will receive in discounts/credits/rebates as well as the procurement fee to be charged. This fosters the goals of transparency and free and open competition. The USDA should consider whether to adopt an approach similar to that utilized in Rhode Island and Minnesota.

4. The proposed rule is overly broad and unfairly sweeps within its grasp discounts that should belong solely to the FSMC.

   As noted in the proposed rulemaking at 69 FR 78342, the proposed rule would apply to all discounts, rebates and credits including prompt payment discounts and volume purchasing allowances. Prompt payment discounts are earned by FSMCs which use their own capital to pay suppliers' bills on an early basis. They incur credit costs in doing so, as well as the opportunity cost attendant to use of cash for early payment rather than investment in other business opportunities. FSMCs clearly earn such discounts with their own assets, and there is no justification for requiring that such discounts be paid over to SFAs.

   Chartwells and other FSMCs also negotiate purchasing agreements in which they commit to purchasing large quantities of product from suppliers. In the case of Chartwells, such arrangements are often based not only upon Chartwells' purchases, but upon aggregate purchasing from all divisions of Chartwells' parent company, Compass Group. Even the largest SFAs do not generate sufficient purchasing volumes to negotiate such incentives; they are only available to FSMCs that have substantial purchasing power. In exchange for Compass/Chartwells' purchasing commitments, suppliers may provide incentive payments conditioned upon achieving minimum purchasing thresholds in a fixed time period. For example, the company may agree to purchase 500,000 pounds of a product over 36 months in exchange for an incentive payment. That agreement would further provide that if the targeted

volume is not achieved, the company must refund some or all of the incentive payment. Not only is it difficult to imagine how such incentives would be allocated among SFAs, but it would be inherently unfair to compel the distribution of such incentives when the FSMC alone bears the burden of achieving purchasing volumes and would be solely liable to the supplier if it does not achieve such volumes. In practical application, if an FSMC was required to distribute a portion of such an advance payment to an SFA, it would be awkward or impossible to require the SFA to reimburse such portion to the FSMC if the FSMC does not achieve the aggregate purchasing requirement and is obligated to return some or all of the incentive payment. The problem would be compounded in a multi-year purchasing agreement, as the FSMC may no longer be providing service to the SFA at the time it is required to reimburse the supplier.

Prompt payment discounts and volume incentive payments also enable Chartwells to offer lower management and administrative fees to SFAs, and therefore reduce costs to SFAs while promoting the efficient delivery of nutrition to children. Chartwells requests that the rule be modified to exclude prompt payment discounts and volume incentive payments from its scope.

5. The broad sweep of the proposed rule also captures contracts in which the FSMC provides a financial guarantee to SFA. Such contracts should be treated as fixed cost contracts for purposes of the proposed rule.

B its terms, the proposed rule applies to all food service management contracts that contain "cost reimbursable provisions" (see proposed 7 CFR 210.21(e) at 29 FR 78347). In the majority of Chartwells' fee based contracts, Chartwells has contractually guaranteed that the food service account will achieve designated financial targets, expressed as assurance that the food service will break even, that it will incur a deficit no greater than a stated number, or that it will achieve a surplus of at least a stated number.

Although such contracts contain fee provisions and provide for cost reimbursement, Chartwells takes profit and loss risk similar to that which it assumes in fixed price agreements. Thus, if costs reach the point that the guaranteed result is not achieved, Chartwells is liable to the SFA for the deficiency. Because Chartwells assumes financial risk in such contracts, it is respectfully submitted that it is inequitable to treat them as cost reimbursable contracts, and Chartwells requests that the rule be modified to exclude such contracts from its scope.

As an alternative to structuring all contracts with FSMCs on a fixed price, as suggested above, the regulations might also be revised to require that all FSMC contracts be awarded on a guarantee basis, with the only variable being the amount of the financial guarantee. By selecting an FSMC offering the best guarantee, an SFA would be assured that its contract provides food service at the lowest overall cost, regardless of management fees, discounts, rebates, and credits. This would serve the goals of transparency and assuring that all FSMCs are on a level playing field, and would provide certainty to SFAs when they assess the cost of their food service programs.

6. The proposed rule would require disclosure of Confidential Business Information, which would be detrimental to FSMCs legitimate business interests and may require breach of contractual confidentiality provisions.

The proposed rule requires individual identification of discounts, rebates and credits, and requires FSMCs to furnish documentation pertaining to same to SFAs, state agencies, and the USDA. (See proposed 7 CFR Section 210.21(e)(iii) and (iv) at 69 FR 78348.

Purchasing agreements are valuable assets of Chartwells. They are negotiated through the efforts of Chartwells, and Chartwells' purchasing skills and strategies are among the strengths that Chartwells offers clients in order to attract and win business. They constitute valuable trade secrets and would lose their value if they became known outside Chartwells.

Moreover, most, if not all, of Chartwells' contracts with suppliers require that the terms of such contracts be kept confidential. In addition to Chartwells' interest in preserving the confidentiality of the arrangements, suppliers have a business interest in protecting their terms, as they would not want other potential or actual customers to be aware of the financial arrangements they have made with Chartwells, which they have negotiated based on Chartwells' aggregate purchasing and other factors. If Chartwells were to reveal the content of its supplier agreements, it would be in breach of such confidentiality agreements. Not only might this subject Chartwells to the risk of legal liability, but it may create grounds for suppliers to terminate such agreements. Further, suppliers who do not wish outside parties to learn the terms of such agreements may be reluctant to enter into future agreements, resulting in the loss of future discounts/rebates/incentives, which would ultimately result in increased costs to SFAs.

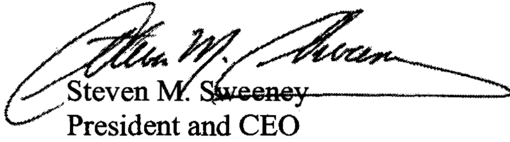
Purchasing agreements are proprietary and often subject to confidentiality provisions which preclude their disclosure to SFAs state agencies, or the USDA. Not only do the suppliers have a legitimate interest in protecting those agreements, but Compass also has a legitimate interest in assuring that this information is not made available to its competitors.

7. The rulemaking should be designated as significant.

Under Executive Order 12866, this rulemaking should be designated as a significant regulatory action. Because it will likely increase the costs to SFAs, it will "materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof." Moreover, it also raises "novel legal or policy issues" arising out of the perceived requirements of either the FAR or the OMB circulars as applied to SFA procurement of services from FSMCs. As such, the rulemaking is appropriately designated as significant to ensure that it receives an appropriate level of review and consideration.

Thank you for the opportunity to provide these comments on the USDA's proposed rulemaking. We look forward to working with the USDA to efficiently provide nutritious meals to our nation's children, and look forward to working with you to improve the regulatory framework.

Sincerely,



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