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DEPARTMENT OF AGRICULTURE

Food and Nutrition Service

7 CFR Parts 210, 215 and 220

RIN 0584-AD38

Procurement Requirements for the National School Lunch, School Breakfast and Special Milk Programs

AGENCY: Food and Nutrition Service, USDA.

ACTION: Final rule.

SUMMARY: The Food and Nutrition Service (FNS) is revising the regulations governing procedures related to the procurement of goods and services in the National School Lunch Program, School Breakfast Program and Special Milk Program to remedy deficiencies identified in audits and program reviews. This final rule makes changes in the school food authority's responsibility for proper procurement procedures and contracts, prohibits the school food authority's use of nonprofit school food service account funds for costs resulting from improper procurements and contracts, and clarifies the State agency's responsibility to review and approve school food authority procurement procedures and contracts. This final rule also amends the Special Milk Program and School Breakfast Program regulations to make the procurement and contract requirements and the consequences for failing to take corrective action in these regulations consistent with the National School Lunch Program regulations. These changes are intended to promote full and open competition in school food authority

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procurements, clarify State agency responsibilities and ensure that only allowable contract costs are paid with nonprofit school food service account funds.

DATES: This rule is effective (insert date that is 30 days after publication in the FEDERAL REGISTER). However, implementation will be phased in for existing contracts. Implementation timeframes are discussed more fully at SUPPLEMENTARY INFORMATION.

FOR FUTHER INFORMATION CONTACT: Melissa Rothstein, Acting Chief, Program Analysis and Monitoring Branch, Food and Nutrition Service, Department of Agriculture, 3101 Park Center Drive, Room 640, Alexandria, Virginia 22302-1594. FAX (703)-305-2879; telephone (703) 305-2590.

SUPPLEMENTARY INFORMATION:

I. Background

On December 30, 2004, FNS published a Notice of Proposed rulemaking (proposed rule) in the Federal Register (69 FR 78340) to remedy deficiencies in school food authority procurement practices that are undermining full and open competition and resulting in unallowable uses of nonprofit school food service account funds. FNS received comments from 16 interested parties within the allotted 60-day comment period. One of the comments was submitted jointly on behalf of the International Dairy Foods Association and the National Milk Producers Federation.

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The proposed rulemaking allowed interested parties the opportunity to request further information from FNS. Three interested parties (food service management companies and their representatives) requested and received the opportunity to meet with us in lieu of requesting the information via other means. These meetings were for informational purposes only. None of the discussions at those meetings constituted comments on the proposed rulemaking.

A. Overview of comments

Fourteen commenters supported either one or both of the proposed rule's goals of improving full and open competition in school food service procurements and limiting nonprofit school food service account expenditures to net allowable costs. All but two commenters raised concerns or objections with one or more of the proposed rule's procedures or requested additional guidance. One commenter only addressed long term beverage contracts and one commenter disagreed that the identification of credits and rebates in cost reimbursable procurement solicitations and contracts would foster greater competition in school food service procurements. No specific comments were received on the proposal to make the procurement and contract requirements and the consequences for failing to take corrective action in the Special Milk Program and School Breakfast Program regulations consistent with the National School Lunch Program regulations.

B. Definitions

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A number of commenters sought confirmation that the definition of contractor would include all contractors to the school food authority, not just food service management companies. The commenters are correct. One comment was received on the definition of nonprofit school food service account. The commenter requested the word "restricted" be further defined. No change to this definition was made because the nature of the restrictions on the use of nonprofit school food service account funds are explained within the definition itself and at §210.14(a).

Additional comments were received seeking clarification whether a purchasing cooperative was included in the definition of a contractor. To date, cooperative purchasing arrangements in the school nutrition programs have taken two main forms. We will use the term "school food service purchasing cooperative" to identify organizations formed by school food authorities, and the term "cooperative buying group" to identify organizations formed by others that school food authorities may join.

School food service purchasing cooperatives range from loosely formed organizations where school food authorities join together to make one or two purchases to separate legal entities that conduct all or almost all of their member school food authorities' purchases. Generally, one of the member school food authorities will act as the leader of the cooperative; however, in some cooperatives, an individual or company may be hired to manage the cooperative. Whether loosely or strictly formed, a school food service purchasing cooperative is not a contractor to its school food authority members, but

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instead acts as their purchasing agent. While each State has statutes concerning the roles and responsibilities of an agent, the general principle is that an agent acts on behalf of his employer. In the case of a school food authority, this means its purchasing cooperative must follow the same rules in acquiring goods and services that its school food service members would follow should the members make the acquisitions themselves. Just as a school food authority is required to comply with the Program and Department procurement regulations, so must its agent, whether that agent is an individual employed by the school food service or a school food service purchasing cooperative.

A cooperative buying group is an existing public, for-profit or nonprofit buying group which usually requires the school food authority to pay a fee to become a member. Generally, these cooperative buying groups have pre-existing arrangements with suppliers, which may or may not have been obtained using competitive procurement procedures that comply with the minimum requirements of the Department. In exchange for paying the membership fee, the cooperative purchasing group offers its members pre-selected items at prices that are generally lower than the price paid at retail establishments for the same items. The price offered for a particular item may be fixed for a specific period of time or subject to change at any point. These pre-selected items may only be available in larger pack sizes or minimum quantity purchase requirements may apply. Unless the cooperative uses competitive procurement procedures that meet the Department's minimum requirements, membership in the cooperative buying group does not satisfy the requirement that the school food authority conduct a competitive

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procurement, nor does the nature of this form of cooperative lend itself to acting as the school food authority's purchasing agent. However, the school food authority can consider the price offered by the cooperative buying group for goods and services meeting the specifications of the school food authority's solicitation when evaluating responses from other potential contractors.

The school food authority is responsible for ensuring its procurements meet regulatory requirements, including the requirements promulgated by this rulemaking. This is true whether the school food authority conducts its own procurements, hires an individual to conduct its procurements, uses a school food service purchasing cooperative or is a member of a cooperative buying group.

Commenters requested that definitions be added to the final rulemaking for fixed price contract, cost contract, cost reimbursable contract and fixed fee. While we agree, we are not adding the definitions for fixed price contract or cost contract to this final rulemaking. The term cost contract is already defined in Department regulations, while the term fixed price contract is not used in the National School Lunch, Special Milk or School Breakfast Program regulations. For the remaining terms, we conducted a search of various materials including regulations, accounting definitions and previously issued policy and guidance to develop appropriate definitions.

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The three definitions previously proposed for applicable credit, nonprofit school food service account and contractor are adopted without changes and definitions for cost reimbursable contract and fixed fee have been added to this final rulemaking for the National School Lunch, Special Milk and School Breakfast Programs at §§210.2, 215.2 and 220.2, respectively.

C. Earned income and prompt payment discounts

While not specifically addressed as a comment on the definition of applicable credits, three commenters requested additional information on whether a prompt payment discount would be an applicable credit. One commenter, experienced in school food service procurements, expressed concern that school food authorities were often charged for the costs of promotional allowances, also known as marketing and incentive funds, that the manufacturers provide to distributors. Additional requests for clarification were received on whether earned income would represent an applicable credit.

Generally, neither earned income nor prompt payment discounts would be applicable credits. However, the deciding factor of whether a particular financial transaction is or is not an applicable credit is based on the transaction itself.

Using the business relationship between a manufacturer and a distributor as an example, earned income is a payment from the manufacturer to the distributor for work performed by the distributor on behalf of the manufacturer. Some examples of earned income

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include payments made to a distributor for promoting new products, hosting trade shows, distributing promotional information, or carrying a particular product in inventory. In each of these cases, the distributor must perform some service to receive the payment from the manufacturer. Therefore, the income is earned and is not an applicable credit to the school food authority.

Applicable credits that would be subject to the proposed regulation include discounts and incentives for volume purchases, credits for returned goods, and rebates paid for the purchase of specific goods. Using the same business relationship identified above, an applicable credit would result from orders placed through the distributor by the school food authority, not some service performed by the distributor on the manufacturer's behalf.

In discussing promotional allowances, the commenter noted that the cumulative effect of such charges may represent more than 25 percent of the item's cost. As discussed above, to the extent such fees represent earned income, these charges are not applicable credits so they do not flow through to the school food authority. As the commenter noted, FNS may not be the appropriate Federal agency to address the issue of whether such charges are generally appropriate, as a commercial practice. We share the commenter's concerns. Based on additional anecdotal information, effective solicitation and contract terms have reduced food costs in one State an average of 18 percent through eliminating unnecessary and redundant promotional allowances.

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While not earned income, a prompt payment discount is a reduction to a billed or invoiced price that results from prompt payment of that bill. Generally, the prompt payment discount is the property of the party using its funds to pay the bill. In the school nutrition programs, this means the prompt payment discount is earned by the school food authority when it pays the bill or when it provides advance funds to another party to pay the bill on its behalf. This is not the funding arrangement used in most distributor and food service management company cost reimbursable contracts with school food authorities. In the majority of these contracts, the distributors and food service management companies obtain goods from suppliers, are billed by those suppliers, pay the suppliers and then deliver the goods at some later point in time to the school food authority. The distributors and food service management companies subsequently bill the school food authority for the goods after their delivery. Since there is usually a time delay between when the supplier must be paid for the prompt payment discount to apply and when the school food authority will be billed for the goods, distributors and food service management companies use their own funds to pay these bills. In these cases, the prompt payment discounts are not applicable credits to the school food authority.

However, we are aware of at least one food service management company that requires a school food authority to provide it with a working capital advance. The working capital advance is then used to pay supplier bills in lieu of the food service management company using its own funds. Since the food service management company is using the

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school food authority's funds to pay its supplier bills, the prompt payment discount is an applicable credit earned by the school food authority. A prompt payment discount would also be an applicable credit when the school food authority voluntarily provides advance funds to a contractor or the contractor requires advance funds or prepayment before ordering products.

D. Application to fixed price contracts

A number of comments were received regarding the applicability of the proposed regulation to fixed price contracts or the fixed fee component of cost reimbursable contracts. Some commenters sought clarification as to whether the proposal would apply to fixed price contracts or the fixed fee component of a cost reimbursable contract, while other commenters asserted that these provisions should not apply, with an additional commenter asserting that school food authorities are not required to determine the allowability of costs resulting from fixed price contracts. Some commenters also suggested that FNS mandate the use of fixed price contracts.

In general, a fixed price contract provides for payment to the contractor at a fixed rate, either at a fixed unit price or a total lump sum price. The agreed upon price does not vary with fluctuations in the costs incurred by the contractor, but the fixed rate may be adjusted at the times and in the manner prescribed in the contract. FNS proposed that school food authorities include specific solicitation and contract terms in cost reimbursable contracts or contracts with cost reimbursable terms. We did not propose

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these same terms be included in fixed price solicitations or the resulting fixed price contracts. Accordingly, this final rule does not require these specific terms in either the solicitation for a fixed price contract or the resulting fixed price contract. The same holds true for the fixed fee component of a cost reimbursable contract. However the cost reimbursable components of that contract would be subject to the requirement that specific terms relative to applicable credits be included.

In asserting that school food authorities would not be required to apply Office of Management and Budget (OMB) cost circulars to expenditures from the nonprofit school food service account for the costs resulting from fixed price contracts, the commenters focused only on one aspect used in determining allowable costs, the net cost factor. Since, as stated above, fixed price contracts generally do not contain cost reimbursable provisions, the proposed rule's limitations on payment of net costs from the nonprofit school food service account would not apply to a fixed price contract unless the fixed price contract also contained a cost reimbursable provision. In that case, the determination of net allowable costs would apply only to the costs resulting from the cost reimbursable provision but not to the fixed price component of the contract. Therefore, the commenters are correct that school food authorities generally do not need to compute net costs in determining the allowable costs under a fixed price contract. However, the commenters are not correct in asserting that school food authorities would be exempt from applying the remainder of the applicable allowable cost rules to expenditures from

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the nonprofit school food service account for the costs incurred under fixed price contracts.

While the net cost component of the allowable cost requirements does not operate in most fixed price contracts, expenditures from the nonprofit school food service account for fixed price contracts must still meet the requirements for allowable costs. Since school food authorities are permitted to contract for both allowable and unallowable costs, a fixed price contract can not be used to circumvent this requirement. For example, a school seeks to contract for janitorial supplies for the entire school building through a single procurement solicitation. The contract will be awarded on a fixed price per item basis. Under the allowable cost rules, the costs associated with the janitorial supplies purchased for use by the school food service would be an allowable nonprofit school food service account expenditure, but the costs associated with the janitorial supplies purchased for the rest of the school would not. The fact that the contract was fixed price would not supersede the cost requirement that, to be allowable, a cost must be necessary, reasonable and allocable to the nonprofit school food service.

The same principles would apply to the fixed price fee of a cost reimbursable with fixed fee contract. We did not propose nor does this final rulemaking require that the costs that comprise the fixed fee be subject to a determination of allowability. However, only the amount of the fixed fees allocable to the nonprofit school food service would be allowable costs.

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One commenter asked whether fixed fee contracts or the fixed fee components of cost reimbursable contracts that were adjusted over time would be subject to the proposed rulemaking. As long as these changes result from contractually agreed upon adjustment factors, such as changes in the reimbursement rates for school program meals or changes in other third party cost or price indices, the adjustments would not be
subject to the provisions of this rulemaking.

Based on anecdotal information, some State procurement statutes and regulations already limit public school food authorities to fixed price contracting, while other State agencies have mandated this form of contracting for specific acquisitions, such as acquiring the services of a food service management company. At this point in time, we do not believe mandating the use of fixed price contracts on a national basis is in the best interest of the school nutrition programs. State agencies and school food authorities, not FNS, should determine whether acquisitions are best suited to fixed price or cost reimbursable contracts. We do recognize, however, that some State agencies and school food authorities are unsure as to which form of contract is most appropriate in a given situation.

E. Payment of net allowable costs from the nonprofit school food service account

While most commenters that addressed the proposal supported limiting expenditures from the nonprofit school food service account to net allowable costs, there did appear to

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be some misunderstanding of this proposal. Some commenters asserted that we were proposing that rebates, discounts and other applicable credits must be returned to the school food authority. Another commenter asserted that the proposal that contractors identify allowable and unallowable costs on invoices would substantially alter the current economic structuring of transactions between food service management companies and school food authorities. These assertions represent a fundamental misunderstanding of our position on the contracting rights of school food authorities.

This final rule does not prevent a school food authority from entering into a contract that results in unallowable costs; it does, however, prohibit the school food authority from using nonprofit school food service account funds to pay for those unallowable costs. The final rule does require the identification of rebates, discounts and other applicable credits, but not the disposition of these amounts. Whether these rebates, discounts and other applicable credits are returned to the school food authority is a decision between the school food authority and its contractor. As stated in the proposed rule at 69 FR 78342, FNS will not interfere in the right of school food authorities to enter into contracts, including contracts with terms that result in unallowable costs. However, we do have the responsibility to ensure that expenditures from the nonprofit school food service account are limited to allowable costs. One of the criteria that the school food authority must use in determining cost allowability is that the cost is net of rebates, discounts and other applicable credits. For this reason, we proposed, and are now adopting, procedures that provide school food authorities with the information they need

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to identify the net allowable portion of their contract costs that can be funded from the nonprofit school food service account and the amount of unallowable contract costs that must be funded from other sources and to inform potential contractors about these reporting requirements. To prevent any future misunderstanding of this distinction, we have added the phrase “from the nonprofit school food service account” at §§210.21(f)(1), 215.14a(d)(1)(i) and 220.16(e)(1)(i) to clarify that the limitations on the payment of allowable and unallowable costs pertain only to expenditures from the nonprofit school food service account.

An additional commenter requested confirmation that contractors would be required to disclose rebates, discounts and other applicable credits whether the amounts were received by the contractor itself, a subsidiary or an affiliate of the contractor. The commenter is correct. The commenter also requested confirmation that the disclosure of such amounts would apply whether the domicile of the contractor is in the United States or otherwise or when these amounts are received by entities under the control of the same parent corporation as the contractor. Again, the commenter is correct. The intent is to promote full and open competition and limit expenditures of the nonprofit school food service account to allowable costs. That would not be achieved if contractors could use their corporate structures to circumvent the disclosure requirements of this rulemaking.

F. Applicability of the Federal Acquisition Regulations to school food authority contracts

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Two commenters asserted that the cost principles contained within the Federal Acquisition Regulations (FAR) should be used to determine allowable costs that result from contracts with commercial organizations rather than cost principles contained in the OMB Cost Circulars (A-87 Cost Principles for State, Local Governments and Indian Tribal Governments and A-122 Cost Principles of Non-profit Organizations) applicable to public and private nonprofit school food authorities, respectively.

Again, we believe the commenters misunderstood. We did not propose a limit on the contractually agreed upon costs that a contractor may charge a school food authority. Rather, we proposed to limit the expenditure of nonprofit school food service account funds to the allowable amount of those costs. The determination on which cost principles apply to a federally funded activity is well settled and consistent across both the FAR (48 CFR 31.103 through 31.107), the OMB cost circulars and the Department's regulations (§§3016.22(b) and 3019.27). The determination is made based on the character of the recipient incurring the costs under the Federal program. Since commercial organizations are not eligible recipients of the school nutrition funds provided by FNS, their only role is that of a contractor to an eligible recipient, i.e., the school food authority. As the eligible recipient of federal funds, a public school food authority will use OMB Circular A-87 to determine whether the costs are allowable, while a private nonprofit school food authority (e.g., in the case of a parochial school) will use OMB Circular A-122 to make this determination. Only when a commercial organization is contracting directly with the Federal government would the FAR (48 CFR

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part 31, Subpart 31.2) and its applicable Cost Accounting Standards (48 CFR 9901.306) be used to determine allowable costs. This final rule maintains the status quo, that being the school food authority, not its contractor, remains responsible for ensuring expenditures from the nonprofit school food service account are allowable costs determined in accordance with the applicable OMB cost circular. This is not a new requirement since school food authorities have been subject to the OMB cost circulars since November 10, 1981, when the Department issued Departmental Regulation at 7 C.F.R. 3015, Uniform Federal Assistance Regulations (46 FR 55640). Further, limitations on claiming only allowable costs have been in place for school food authorities since at least January 1, 1967 (32 FR 33).

We believe the commenters desire to apply the FAR to school food authority contracts arose from two different issues raised by these commenters. The first, as stated above, is a misunderstanding that we were proposing to limit the costs that contractors could bill to school food authorities, while the second concerns the recovery of overhead expenses from retained rebates and discounts.

In the first issue, the commenter asserted that we were proposing to apply the OMB cost principles to commercial organizations contrary to information we had previously issued and that, as a commercial organization, the cost principles of the FAR should apply instead. We did not propose a change to the requirements that the school

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food authority, not the contractor, is responsible for ensuring that all expenditures from the nonprofit school food service account meet the allowable cost rules. This responsibility rests with the school food authority, but the school food authority cannot make an informed decision about cost allowability without information from its contractor. In seeking to determine the least burdensome method for school food authorities to obtain this information from their contractors, FNS proposed that contractors identify, on invoices to school food authorities, allowable and unallowable costs determined in accordance with the OMB cost circulars. The four other alternatives we considered when developing this proposal included maintaining the status quo; requiring that contractors provide source documentation to school food authorities for all costs charged; requiring that contractors have an annual audit for each cost contract with a school food authority to determine allowable and unallowable costs; or requiring that contractors include only allowable costs on invoices.

The first alternative was rejected because Office of Inspector General audits and investigations indicated that nonprofit school food service account funds have been expended for unallowable costs because the school food authority had insufficient information to identify unallowable costs included on invoices. The second alternative was rejected because it would be excessively burdensome on contractors to provide this information; while the third alternative was rejected because it would be both burdensome and cost prohibitive for contractors to incur annual audit costs for each of its cost reimbursable contracts with school food authorities. The fourth alternative was

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rejected because it would interfere with the school food authority's right to enter into contracts that contained costs that were unallowable nonprofit school food service account expenditures, but nevertheless represented costs the school food authority was willing to fund from other sources.

However, FNS has reconsidered this fourth alternative for two reasons. First, a school food authority can elect to contract only for allowable costs. In these cases, we recognize that requiring contractors to identify allowable and unallowable costs under such contracts would be an unnecessary burden on contractors because only allowable costs can be reported on the billing documents. Second, we are concerned that some school food authorities may misunderstand that a contractor's identification of allowable and unallowable costs on invoices applies only to the costs reported by the contractor, not to the school food authority's expenditures from its nonprofit school food service account. If our previous example of a janitorial supplies contract was cost reimbursable instead of fixed price, pursuant to the provisions of this final rule, the contractor would appropriately identify all of the janitorial supplies sold to the school food authority as allowable costs on its monthly invoice. This determination by the contractor does not mean the school food authority can fund the entire cost of its janitorial supplies contract from its nonprofit school food service account. The school food authority would still be required to fund only its share of the janitorial supply costs from its nonprofit school food service account.

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As a result of this reconsideration, we have revised §§210.21(f), 215.14a(d) and 220.16(e) to allow school food authorities to choose between two cost reporting provisions for its solicitation documents and contracts. The first cost reporting provision finalizes the provision contained in the proposed rulemaking that contractors identify allowable and unallowable costs on billing documents. The second cost reporting provision requires contractors to exclude unallowable costs from billing documents and to certify that only allowable costs are submitted for payment and that records have been established that maintain the visibility of unallowable costs, including directly associated costs, in a manner suitable for contract cost determination and verification. Regardless of the cost provision chosen, contractors would still be required to report discounts, rebates and other applicable credits and school food authorities would still be required to limit expenditures of nonprofit school food service account funds to net allowable costs.

The second issue concerning the applicability of the FAR to school food service contracts focused on the recovery of administrative cost overhead charges from retained discounts and rebates. In this case, the commenter asserted that contractors should be allowed to retain rebates and discounts to cover their corporate indirect costs that they do not include in the fixed fee component of their cost reimbursable contracts and such actions were permissible for contractors subject to the FAR at 48 CFR part 31, Subpart 31.2. The commenter further asserted that FNS should allow such practices. We disagree. Focusing on just one paragraph of the FAR cost principles fails to consider the entire

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body of the principles. The FAR does not apply to school food service contracts. We do not adopt these principles in this rule either.

This commenter also asserted that even if the FAR did not apply to contracts with school food authorities, the OMB cost circulars would allow it to retain the rebates, discounts and other applicable credits earned on the cost component of its contracts to offset its administrative costs charged through its fixed fee. Again we disagree.

First, as stated previously the OMB cost circulars do not apply to a school food authority's contractor, but to the school food authority's expenditures from its nonprofit food service account. Second, the effect of the commenter's position could unnecessarily increase nonprofit school food service expenditures.

A cost reimbursable with fixed fee contract consists of the cost component and the fixed fee component. The rebates, discounts and other applicable credits subject to the rulemaking are earned through the cost component of the contract, not the contractor's fixed fee component. We have concluded that the retention of undisclosed rebates, discounts and other applicable credits creates an unreasonable incentive for a contractor to seek out goods which provide the highest rebates, discounts and applicable credits regardless of whether these products offer the best value at the best price to the school food authority.

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In submitting its offer under a cost plus fixed fee solicitation, the contractor submits a fixed amount for the fixed fee component. If FNS accepted the commenter's position, the contractor would need to estimate the amount of rebates, discounts and other applicable credits that may result from the purchases (the cost component of the contract) that it will make on behalf of the school food authority and apply these amounts to its calculations when computing the fixed fee it will offer. Underestimating these amounts would result in a windfall to the contractor because its fixed fee plus the retained rebates, discounts and other applicable credits would exceed its allocable overhead costs, while overestimating these amounts would result in a contractor losing money since the retained amounts plus its fixed fee would not be sufficient to cover its corporate overhead and indirect costs. In either case, there is no incentive for the contractor to seek out products that do not offer rebates, discounts or other applicable credits even when these products offer the best value for the school food authority.

When the school food authority accepts the contractor's offer, it expects to pay the fixed fee plus the costs incurred under the cost component. This final rulemaking requires that the contractor disclose the rebates, discounts and other credits applicable to the cost component. The school food authority will determine the net allowable costs for the cost component of its contract and use nonprofit school food service account funds to pay its net allowable costs plus the fixed fee component. The commenter's proposal would result in the school food authority using nonprofit food service account funds to pay the full cost, not net cost, for the cost component, plus the fixed fee component while the

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contractor retained the full amount of the discounts, rebates and other applicable credits earned by the school food authority.

Further, FNS accepted the commenter's position it could provide a potential contractor with an unfair competitive advantage. Without full disclosure of the costs a contractor will actually charge, full and open competition is compromised because the school food authority cannot determine which of the respondents has made the most advantageous offer, price and other factors considered. The outcome of the commenter's position would be that a school food authority could not rely on the price a contractor bid and the contractual agreement it entered.

This final rulemaking does not require a contractor include its full administrative costs in its fixed fee since the decision on how to establish the fixed fee component of a cost reimbursable contract is a business decision and a company may choose to recover less than its full costs to gain a competitive advantage and win a contract award. However, the principle of a fixed price is that the price is fixed in the manner and for the period of time specified in the contract. We are not aware of any cost principle or procurement provision that permits a contractor to increase the fixed price component of a contract without disclosure of the change and the agreement of the other party to the contract. When a potential contractor submits a fixed price offer, is awarded a contract based on the price and then contractually agrees to that price, the contractor does not have the right

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to violate the terms of its contract by increasing that price by retaining undisclosed rebates, discounts or other applicable credits.

Since the commenter failed to disclose why it chose not to include its full administrative costs in its fixed fee, we are concerned that the commenter may not be aware that the fixed fee is the component of a cost reimbursable contract through which the contractor should charge these costs, as well as its profit. This confirms one of the key points underlying the issuance of the proposed regulation, that being, without clear disclosure by the school food authority to potential contractors on how costs must be billed to the school food authority, competition can be compromised because a potential contractor does not have sufficient information to determine which costs should be included in its fixed fee.

There is no barrier within the cost principles, Department or program regulations that prevents a contractor from including its full administrative costs, including all of its allocable overhead costs and indirect costs, in its fixed fee. Since there is no prohibition on including these costs in the fixed fee, we have included information in the newly added definition of fixed fee at §§210.2, 215.2 and 220.2 to clarify that the fixed fee includes the contractor’s direct and indirect administrative costs and profit allocable to the contract. A potential contractor is free to determine whether or not to include the full amount of its overhead and indirect administrative costs allocable to a contract in its fixed fee component. However, if a potential contractor chooses to exclude these costs

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from the fixed fee component, attempting to recover these unbilled costs by retaining undisclosed discounts, rebates and other applicable credits earned by the school food authority's purchases of foods and supplies creates an unacceptable barrier to full and open competition and may result in unallowable expenditures from the nonprofit school food service account.

G. Guaranteed return provisions

The same commenter also raised the issue of the risks contractors, particularly food service management companies, incur when including guaranteed return provisions in contracts and requested that contracts containing such provisions be considered fixed price for purposes of the final rulemaking. The commenter asserted that providing a guaranteed return causes its company to take profit and loss risks similar to what it assumes in fixed price contracts. The commenter further offered that since its company assumes financial risk by agreeing to the guaranteed return provision it would be inequitable to treat the contract as cost reimbursable and instead the contract should be viewed as fixed price, thereby eliminating the need for the company to include rebates, discounts and other applicable credits on bills and invoices submitted to the school food authority.

We disagree. Guaranteed return provisions do not substantially alter the terms of a contract as to convert it from cost reimbursable to fixed price. Furthermore, guaranteed

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return provisions are neither new nor unique to the commenter's contracts, nor are these provisions limited to cost reimbursable contracts.

In their current form, most of these guaranteed return provisions do not place successfully performing contractors at risk. As the commenter noted, guaranteed return provisions provide a financial assurance that certain contractual promises made to the school food authority will be met. Guaranteed return provisions have been included in food service management company contracts for many years, but the terms of the provisions have changed over time. Initially, the provision guaranteed a fixed payment to the school food authority or that the food service management company would meet a specific financial target. More recently, some guaranteed return provisions have been modified to limit a food service management company's liability for its failure to meet contractually agreed upon financial targets. In reviewing recent contracts from a variety of food service management companies, one form of the guaranteed return provision reads:

> Company guarantees that the District's 2003-2004 food service program will achieve the mutually agreed upon financial parameters. If the mutually agreed upon financial results are not met, (the Company) shall reimburse the District an amount commensurate with the variance up to a maximum of the total annual amount for (the Company's) management fee.

In our opinion, the wording of this provision does not place a contractor at great risk. The contractor has not been forced to accept a specific financial outcome but mutually agreed to it. We would not expect a contractor to agree to a financial guarantee that it

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did not expect to meet. Taken in its entirety, this provision does not guarantee a specific financial outcome, but instead serves to limit the financial liability of the contractor for its failure to meet a contractually agreed upon result, no matter how great the loss sustained by the school food authority under the contract.

Entering into a contract with a school food authority is a voluntary act. There is no requirement that a contract be drafted to eliminate all possible risk to a contractor, nor is a school food authority required to indemnify its contractor against all potential risks that might occur, particularly those that the contractor has agreed to accept.

Further, while a guaranteed return provision should serve to make the school food authority whole or at least reduce the amount of loss it must bear, some guaranteed return provisions require repayment of the forfeited funds. These provisions require that the school food authority repay the forfeited guaranteed return to the contractor in a subsequent year in the event the contractor meets its contractual obligations for that subsequent year. The result is that the school food authority must subsidize a contractor's nonperformance by bearing the full cost of the contractor's failure under the prior contract. We must also note that this subsequent recovery is not an allowable nonprofit school food service account expense since it shifts the payment of the prior year's management fee to a current year. A school food authority must fund this payment from other than its nonprofit school food service account. Fortunately, most food service management companies strive to meet their contractual obligations and

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share in the Department's goal of providing nutritious, low cost meals to children. This commitment minimizes the effect that the guaranteed return provision could have on a school food authority should its contractor substantially fail to meet the financial results guaranteed in the contract.

It is reasonable to allow a contractor to receive payment from the nonprofit school food service account for undisclosed rebates, discounts and other applicable credits to mitigate any risks that the contractor might incur under a guaranteed return provision. However, it is our position that school food authorities need to better understand the effect of the current guaranteed return provisions.

H. Contractor administrative costs

On the subject of administrative cost charges, one commenter asserted that contractors should have the option of charging the school food authority a fee for late payments. The commenter did not explain why he believed such charges were prohibited or how the proposed rule would interfere in a contractor's right to include in a contract with a school food authority, a provision requiring payment of late fees. Our position on this subject remains unchanged. There is no provision in this final rule or the Child Nutrition Program or Department regulations that would prevent a contractor from imposing a fee when the school food authority fails to pay its debts in a timely manner. When questions have been presented about the imposition of late payment fees in the past, FNS has affirmed the right of contractors to request and enforce such provisions in contracts, as

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long as such provisions do not conflict with applicable State and local laws and regulations. We also continue to maintain the position that the school food authority can not use its nonprofit school food service account to pay the cost of such fees. These payments represent fines and penalties, which are unallowable costs under the applicable OMB cost circulars. In keeping with the provisions of this final rulemaking, the contractor would be required to identify the late payment charge on its billing documents as an unallowable cost. However, as discussed earlier, there is no prohibition against a school food authority entering into a contract that contains unallowable costs.

Two commenters requested clarification that any added costs resulting from implementing this final rule would be allowable charges to the school food authorities. Neither of the commenters specifically identified where they would incur increased costs or the amount of any increase; but we would expect any increased costs would be incurred in the allocation and records maintenance of rebates, discounts and other applicable credits to school food authorities and the identification and reporting of allowable and unallowable costs. Contractors already track the costs that are billed to school food authorities and have accounting and billing systems in place for school food authority contracts. Further, under generally accepted accounting principles and good business practices, these contractors maintain systems to track and report rebates and discounts. Any additional costs incurred by contractors for implementing the provisions of this regulation are an element of a company’s administrative expenses allocable and includable in the fixed fee component of a cost reimbursable contract. The decision as to

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whether to record the expense as an overhead, accounting or management cost is a corporate financial management decision.

FNS does not support including these costs in a new, separate fee as asked by one commenter who cited a contract amendment negotiated with a specific State agency. Based on information provided to us, the State agency chose to require its school food authorities to rebid any food service management company contract that lacked the return of rebates and discounts. In response, one food service management company agreed to return rebates and discounts in exchange for the right to directly offset the rebates and discounts against its increased costs so that the school food authorities currently under contract would not need to rebid their contracts. We find the terms of this type of provision unreasonable and unnecessary. The method of cost recovery established by the provision would impose overly burdensome cost accounting and paperwork requirements on contractors. The end result would be unnecessarily increasing costs to contractors and to school food authorities. Since the contractor must be able to provide records supporting every direct cost charged to a school food authority under a cost reimbursable contract, if this method of cost recovery was permitted, the contractor would need to establish and maintain accounting records sufficient to meet this requirement. Among these records would be detailed cost allocation worksheets individually, by contract, to track each employee's time spent on this function to support the charges assessed against each school food authority and similar accounting records for every other cost supporting this function (communication costs, office supplies, etc.). This would be in addition to

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allocating the credits, discounts and rebates for each school food authority. This additional recordkeeping is unnecessary. Crediting and tracking rebates and discounts is an accounting function. The costs associated with a contractor's accounting system are administrative costs that are appropriately charged to school food authorities through the fixed price component of the contract. As discussed above, we have included new regulatory language at §§210.2, 215.2 and 220.2 to address the elements of the fixed fee component of cost reimbursable contracts. While we did not find the commenter's suggestion acceptable, we do appreciate the commenter raising the issue of multiple fees and charges for administrative and overhead expenses.

In regulations published on January 18, 1969, FNS first permitted school food authorities operating under a contract with a food service management company to participate in the National School Lunch Program under a pilot program (34 FR 807). On March 1, 1969, we issued prototype agreements for use by these school districts (34 CFR 3704-3709). At that time, the only form of payment to a food service management company was a fixed price per plate or other unit of food served or delivered that included the contractor's full costs and profit. The food service management company was required to purchase food for the account of the school food authority with invoices sent directly to the school food authority for payment. However, the cost of such food purchases was limited to the amount agreed upon between the food service management company and the school food authority (34 FR 3704). In effect, this contract was a cost reimbursable with a cap on costs plus a fixed management fee.

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Over time, the limit on costs was abandoned. Currently, food service management company contracts are either an inclusive fixed price per meal or cost reimbursable with a fixed fee (without a cap on costs) contracts. We understand that the vast majority of all food service management company contracts are cost reimbursable with a fixed fee. We have noted when reviewing some of these contracts, that a single fixed management fee has been replaced with multiple fees. All of the fees we reviewed were for components of a food service management company's administrative costs. Some fees were per meal or lump sum payments for general and administrative costs that were paid monthly or annually in addition to a per meal management fee. In another contract, there was an additional per meal technology fee for license renewal, software upgrades and technical support. At this point, we have determined that the best approach to deal with its concerns on multiple fee structures is through training and technical assistance to State administering agencies, which in turn would train school food authorities.

One commenter requested that the final rulemaking address the issue of amending contracts to address new costs or charges mandated by changes in policies, legal or regulatory requirements. Most of the school food authority contracts we have reviewed already contain provisions which permit such changes. Nothing in this final rulemaking prevents a school food authority from including in its contracts, terms which permit amendments to address such changes, nor are contractors prohibited from requesting that school food authorities include such provisions in their contracts.

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I. Training and Technical Assistance

Many commenters, particularly State administering agencies and the School Nutrition Association, requested training and technical assistance on this final rule as well as on procurement requirements and allowable costs in general. The Department agrees and intends to conduct training on this rule after publication and will continue to issue guidance as the need arises. However, neither the Department's planned training nor its guidance will address specific State and local procurement requirements. Public school food authorities must follow their own applicable State and local procurement procedures and will only revert to Federal requirements when applicable State and local requirements are less restrictive. We are not the appropriate source for interpreting State and local requirements or for providing training on these requirements. We encourage State administering agencies, school food authorities and industry partners to look for these resources within their own State and local jurisdictions. Additionally, procurement information is available through the internet and from a number of nonprofit and commercial consulting companies.

J. State agency review of procurement documents

One commenter was concerned that the proposal for the State agency to review the school food authority's food service management company contract prior to its execution would place a substantial burden on the State agency. The commenter viewed this review as a new requirement. It is not. FNS only proposed to change the timing of this

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review, not its scope. One State agency suggested that a school food authority's compliance with procurement requirements be included in the Single Audit. Since an audit is conducted on a prior period, it would be too late to correct any deficiencies that are found. Generally the only option to respond to audit deficiencies is to disallow the costs associated with noncompliance and seek corrective action to prevent recurrence of the problem. Cost disallowances can seriously undermine the financial integrity of the school's nutrition programs for children

Our intent in moving the State agency review of food service management company contracts from after execution to before execution is to provide a means for identifying and correcting problems in contracts before they are executed. This approach would ensure that school food authorities are not routinely subject to cost disallowances. Another State agency expressed concern that the proposed rule at §210.19(a)(6) would require a State agency to review previously approved prototype food service management company contracts even when no changes had been made to the contract. This was not our intent nor do we believe this will occur. This final rulemaking requires school food authorities using a State agency pre-approved prototype food service management company contract to obtain prior written approval of the State agency only when changes are made to that contract (§§210.16(a)(10) and 220.7(d)(1)(ix)). We have added a corresponding sentence at §210.19(a)(6) to clarify that when a school food authority is using a State agency prototype food service management company contract, the State agency is only required to review the changes made to that prototype contract.

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A third State agency, which from the description of its current actions already has an extensive preapproval process for food service management company contracts, expressed concern that the proposed change would add an additional review on top of the review it already performs. Our Regional offices will work with individual State agencies to ensure that any changes resulting from implementing this final rulemaking do not duplicate or diminish a State agency’s current approval process. Two State agencies indicated that pre-execution reviews of food service management company contracts is already occurring, three additional commenters supported the proposal and one commenter, a former State agency director, also supported the proposal.

One commenter suggested nonsubstantive rewording of certain sentences at §210.16(a)(9) and (a)(10). We agree that the commenter’s proposed changes make the provisions easier to read and have amended §210.16(a)(9) and (a)(10) and the corresponding provisions at §220.7(d)(1)(viii) and (d)(1)(ix).

Other commenters requested that the regulation permit the State agency flexibility in establishing due dates for school food authority procurement documents and two commenters requested more specific regulatory authority to withhold payments when school food authorities fail to comply with a request for timely submission of required documents. While we believe sufficient regulatory authority already exists to permit State agencies to establish reasonable due dates consistent with their resource and work

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load limitations, we have amended the proposal at §§210.16(a)(10), 210.19(a)(6) and 220.7(d)(1)(ix) to explicitly permit State agencies to establish due dates for submission of the documents needed for this approval. Failure of a school food authority to respond to these due dates would result in regulatory noncompliance and the school food authority's failure to correct this deficiency could result in the withholding of reimbursement pursuant to §§210.22 and 220.18.

K. Procurement procedures

Three commenters raised issues with procurement procedures in general. The first asked that we consider permitting cost plus percentage of cost contracts. The commenter's rationale for allowing this procurement method was that this form of contract costing may be the most cost effective procedure for school food authority bidding. We did not find this argument persuasive in light of the allowable contract cost methods that are available to school food authorities. In a cost plus percentage of cost contract, the contractor earns its fee based on a percentage of the cost of goods it sells under the contract. This contract cost method is prohibited government-wide because this form of contract pricing provides no incentive for a contractor to control costs. In fact, it serves as an incentive for the contractor to seek out the highest priced goods possible since the contractor's fee will increase by buying more expensive not necessarily better goods. A school food authority should be aware of the cost factors that a contractor will incur during the course of its contract and use the contract cost method that will encourage full and open competition and treat its contractors fairly. There are a number of allowable

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contract cost methods that can respond to price fluctuations that are beyond a contractor's control such as seasonal product availability and fuel costs.

The second commenter expressed concern that our position that competition is required for all procurements would prevent school food authorities from taking advantage of "value added" products or consider factors, other than price, in awarding a contract. This commenter, as well as others, also expressed concern that school food authorities that failed to use sealed bids or competitive proposals to acquire all of the items to be purchased during the school year would be penalized. As the commenter noted, nothing in the proposed rule addressed these concerns. However, these comments reflect procurement practices that are frequently misunderstood and we will use this opportunity to clarify these issues once again.

In the commercial sales sector, the term "value added" has a number of applications. In its simplest form, it means providing the customer with an enhancement that the customer values. This enhancement can be personalized service, customized delivery or a product with a particular form of packaging. This added value may or may not result in an increased cost to the purchaser. Unfortunately, it appears that some school food authorities have used the term "value added" to circumvent proper procurement procedures. In the best case, a value added product exceeds the school food authority's specifications at the lowest price. In the worst case, the product offered is nonresponsive to the bid specifications.

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Despite a school food authority's best efforts, the specifications it develops for a particular product may not represent the most appropriate or best product for its needs. Potential suppliers with their knowledge and experience may have products that would better suit the school food authority's needs. The best time for a school food authority to obtain this information is before it develops its solicitation information. Suppliers can assist school food authorities in this effort by alerting them to new and innovative products and services throughout the school year. This educational effort can occur through sales visits, trade shows, promotional literature and a variety of other means. However, it is not appropriate for a school food authority to select products that do not meet solicitation requirements. While a potential supplier may indeed have a better product, if that product does not meet solicitation specifications, the school food authority cannot use the phrase "value added" to circumvent proper procurement procedures. If the school food authority determines that the value added product is more appropriate than the product it specified in its procurement solicitation, the school food authority needs to issue a new solicitation or wait until its next bid cycle to change its specifications. This does not mean, however, that a school food authority must take the lowest price offer when the product offered does not meet the specifications of its solicitation.

This reflects a pervasive misunderstanding by school food authorities and their contractors that the competitive proposal method of procurement provides a school food

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authority more flexibility in selecting a contractor than does the sealed bid method when acquiring commercially available products. Since virtually all goods and services sought by school food authorities are commercially available, the differences between sealed bids and competitive proposals are minimal. Equally important, the sealed bidding method does not prevent a school food authority from seeking innovative products and services.

In a sealed bid, the award is made to the responsive and responsible bidder, whose price is lowest (§3016.36(d)(2)). Lowest price does not mean a school food authority must accept the cheapest offer. It means the school food authority selects the most responsive bid with the lowest price. When using competitive proposals, the school food authority is required to consider price and other factors (§3016.36(d)(3)(iv)) in awarding its contracts. It is important to note that like sealed bidding, price is still the primary consideration in awarding a contract under the competitive proposal method.

An adequate description of the material, product or service to be purchased is required whether the sealed bidding or competitive proposal method is used (§3016.36(c)(3)(i)). When a commercially available item will be purchased, the description in the request for proposal is the same information that would be contained in an invitation for bid under sealed bidding, i.e., that product's specifications. Further, the criteria for determining bidder responsiveness that would be included in the invitation for bid can include the

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same information that would be included in a request for proposal to identify the other factors that will be considered in awarding a contract.

To illustrate this concern, one commenter offered an example in which a school food authority sought to obtain milk for reimbursable meals and a la carte sales and requested that offerers propose other products for consideration. Student taste testing was also required. In the example, one potential contractor offered products for the reimbursable meals as well as wide range of innovative products and ideas for both reimbursable and a la carte sales. This potential contractor's price for the reimbursable meal products was lowest, while the price for the a la carte items was higher than another competing offerer that did not provide the same range of products and services. The commenter believed that only a request for proposal would allow the school food authority to award the contract to the offerer which offered the widest range of products. That is not correct. In the same example under sealed bidding, the school food authority would determine that the potential contractor which provided the widest range of products and services was the most responsive bidder. At that point, the only issue remaining would be whether another potential bidder was equally responsive. When this situation occurs under sealed bidding, the deciding factor would be which of these two responsive bidders offered the lowest total price.

The final issue raised by this commenter and others was that school food authorities would be penalized if they failed to use either sealed bidding or competitive proposals to

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purchase every item needed during the school year. This is not the case, but does represent a common misunderstanding that the term "competitive procurement" means that either the sealed bid or competitive proposal method must be used. Some form of competition is required for every purchase, but not every purchase is subject to the formal (sealed bid or competitive proposal) solicitation methods. There are many items that are purchased in such small quantities that it is not cost effective for the school food authority to conduct a formal procurement to acquire these items. Just because a purchase will not meet the formal procurement threshold does not mean the school food authority is exempt from competitively procuring the purchase. In these situations, the school food authority would use the simplified small purchase procedures to acquire these items of minimal value.

The third commenter sought clarification as to whether a contractor in a cost reimbursable food service management company contract would be required to conduct competitive procurements to obtain the goods and services billed to the school food authority. The commenter did not support such actions and questioned whether such actions were required under the proposed regulation. While this specific issue was not the subject of the proposed rulemaking nor is it the subject of this final rulemaking, we believe the commenter's concern merits a response.

The situation the commenter addressed can result through an intentional decision of the school food authority to delegate procurement responsibility to its food service

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management company. Alternatively, it can be the unintended result of a school food authority failing to conduct a proper procurement for a cost reimbursable contract School food authorities are required to competitively procure all goods and services (§210.21). In conducting its procurement for a food service management company, a school food authority is required to identify detailed specifications for each food component. These specifications must cover items such as grade, purchase, units, style, condition, weight ingredients, formulations and delivery time (§210.16). The school food authority may meet its food procurement obligations by including sufficient information in its solicitation and contract with its food service management company; by conducting separate procurements for food and supply items itself; or when permitted under applicable State and local requirements, delegating the responsibility to its agent. We have reviewed a number of food service management company solicitations and contracts in which the school food authority has failed to include food specifications or its expectations on how food would be acquired, but instead designated the food service management company as its agent. This designation can result in creating an obligation for the food service management company to conduct separate procurements on behalf of the school food authority, even when this was not the school food authority's intent. School food authorities that require food service management companies to conduct separate procurements on their behalf need to be aware that such requirements may create conflicts with the food service management company' pre-existing supplier contracts and agreements and may substantially increase administrative costs. We believe most school food authorities are not aware of the situations they are creating by

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failing to address food acquisitions in their cost reimbursable food service management company solicitations and contracts.

L. Confidentiality and timing issues

Three commenters raised concerns of varying degrees with the protection of the confidential business arrangements when reporting discounts, rebates and other applicable credits. Other commenters expressed concerns with the timing of the reporting of these amounts to the school food authority. FNS is sensitive to the commenters' concerns related to confidential business relationships. We agree with the commenters that the reporting of discounts, rebates and other applicable credits should not compromise business relationships that have been promised confidentiality. We were aware that such confidential business relationships could exist and we considered these relationships in developing the proposed regulation. For this reason, FNS proposed that the contractor individually identify discounts, rebates or applicable credits on the bills and invoices but did not propose that the contractor identify the source of the discount, rebate or other applicable credit on the invoice.

Some commenters perhaps misread the provision to mean that the source of the discounts, rebates and applicable credits had to be identified on the bills and invoices. To eliminate the possibility that readers could misinterpret this requirement, we have amended this final regulation at §§210.21(f)(1)(iv), 215.14a(d)(1)(iv) and 220.16(e)(1)(iv). The amended language clarifies that the contractors are only required to identify the

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amount of each discount, rebate or applicable credit on the bill or invoice and whether the amount is a rebate, discount, or in the case of some other form of applicable credit, the nature of that credit.

There are a number of ways for a contractor to provide sufficient information on its billing documents about the nature of the amounts reported without compromising its confidential business relationships. The contractor could provide the school food authority with a list of products upon which a rebate, discount or other applicable credit could be earned during the term of the contract and then report the amount of rebates, discounts and other applicable credits in aggregate on billing documents to the school food authority; the contractor could identify the rebate, discount, or other applicable credit by earning period, i.e., for products purchased during the month of April or the contractor could identify the rebate, discount or applicable credit by invoice number. Since not all contractors will use the same method to record and report rebates, discounts and other applicable credits within their corporate recordkeeping systems, FNS does not wish to prescribe the specific method that should be used to identify these amounts on school food authority billing documents.

This final regulation does not require the reporting of confidential business information on bills and invoices. However, it does require that the contractor maintain records and source documents in support of the costs and discounts, rebates and other applicable credits included on bills and invoices to the school food authority and make them

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available to the school food authority, State agency and Department upon request. This record retention requirement is no different than the existing requirements found in Department regulations at §§3016.36(i)(10) and 3019.48(d). Contractors have always been required to maintain source documents in support of the costs charged to school food authorities. The intent of the respective program provisions at §§210.21(f)(1)(iv), 215.14a(d)(1)(iv) and 220.16(e)(1)(iv) and the record retention requirements in the Department's regulations is to provide sufficient information to permit a school food authority to determine the amount of costs billed by its contractors that can be paid from the nonprofit school food service account and permit a subsequent review of the contractor's source documents to verify that the amount of cost, rebates, discounts and other applicable credits had been properly reported under the terms of the contract.

In commenting on the timing for reporting discounts, rebates and other applicable credits, one commenter suggested requiring potential contractors to bid prices as if the discount, rebate or other applicable credit had already been earned, with a subsequent reconciliation at the end of the contract. Other commenters raised questions about how these amounts, specifically volume purchase discounts, should be reported during and after the term of the contract, when the amounts do not become realized until after expiration of the

contract under which the earning activity occurred.

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We considered the option of requiring prices to be bid less discounts, rebates and other applicable credits; however, we do not believe this will improve full and open competition or maintain the integrity of the nonprofit school food service account given the current state of school food authority procurements. As discussed in the proposed rule, most schools using cost reimbursable with fixed fee contracts do not consider the costs of goods or services when using this solicitation method, but instead award the contract on the lowest priced fixed fee cost. Many school food authorities do not even require potential contractors to submit the cost of the goods or services in the response to this form of solicitation. While it is not appropriate to use only the cost of the fixed fee component in determining contract awards under this solicitation method, we recognize that this is common practice. We will continue to work toward resolving these deficiencies in the solicitation and award of cost reimbursable contracts. However, until such time as school food authorities begin to consider the cost of goods and services in addition to the fixed fee cost in this form of solicitation and contract award, requiring contractors to submit bids with price reductions included would be meaningless. Further, an annual reconciliation could impose a financial hardship on the contractor and the school food authority should the anticipated discounts, rebates or other applicable credits fail to materialize during the year. In this situation, the school food authority would have to pay the difference to the contractor at the end of the contract period, while the contractor would be underpaid for a substantial period of time.

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Commenters suggested alternatives to reporting discounts, rebates and other applicable credits on other than a monthly basis. The majority of these commenters viewed the requirement to report discounts, rebates and other applicable credits as a requirement to return these amounts to the school food authority and the alternatives proposed addressed mechanisms for this return. This final rulemaking requires the disclosure of these amounts, not their disposition. School food authorities and their contractors are free to determine whether or not these amounts are returned to the school food authority and the method by which any return will occur. We do agree that less frequent reporting of discounts, rebates and other applicable credits could reduce the burden on both contractors and school food authorities. Since we are encouraging State agencies to take a more active role in school food authority procurements, we have amended the proposed regulation at §§210.21(f)(1)(iv), 215.14a(d)(1)(iv) and 220.16(e)(1)(iv) to permit State agencies to approve reporting on other than a monthly basis, but not less frequently than annually. Since the use of other than monthly reporting is an option, a State agency may choose to permit or deny such reporting on an individual contract basis or decide on a State-wide basis. Further, since this option is at the discretion of the State agency, the State agency is not required to justify its decision to require monthly reporting.

The final subject of comments on the issue of timing concerned the reporting of discounts, rebates and other applicable credits that result from contract activity, but are not earned or received by the contractor until after the contract has ended. While some rebates, discounts and other applicable credits will be known to the contractor when bills

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are issued to the school food authority others, particularly volume discounts, may not be known until some point in the future. For example, a volume purchase discount is earned when a sales of a particular item reaches an established target. The contractor may not reach the target sales volume until after the school food authority's contract has ended, even though the purchases by the school contributed to reaching the target volume. This could occur when the timing of the school food authority's contract does not coincide with the timing of the volume discount earning period, or even when the timing of the contract and the volume discount earning period is the same but the contractor does not receive the benefit of a volume discount, rebate or other applicable credit until after the school food authority's contract has concluded. The method for providing the rebate, discount or other applicable credit information in this situation depends on whether the contractor and the school food authority maintain an on-going, uninterrupted, contractual relationship, i.e., a subsequent or renewal contract is in place. When the contractor and the school food authority's contractual relationship is uninterrupted, the contractor can include the rebate, discount or other applicable credit with its next reporting period. For those situations in which the contractor and school food authority do not maintain an uninterrupted contractual relationship, the amount of the discount, rebate or applicable credit should be provided to the school food authority once these amounts are known to the contractor. Depending upon the school food authority's financial management practices, the school food authority may need the contractor to identify the period in which the rebate, discount or other applicable credit was earned so that it can adjust its

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accounting records accordingly. In these cases, the contractor would need to provide sufficient information to permit the school food authority to identify the appropriate accounting period requiring adjustment.

We agree with the commenter that the proposed regulatory provisions should be clarified to address this issue. We are amending the proposed regulations at §§210.21(f), 215.14a(d) and 220.16(e)(1) to require school food authorities to include specific directions in solicitations and contracts for reporting rebates, discounts and applicable credits after the close of the contract to which the cost reductions apply.

M. Ethics in Long Term Beverage and Food Service Management Company Procurements

We sought comments on whether additional regulatory action is needed concerning ethical practices citing concerns with the procurement of long term beverage and food service management company procurements. FNS had not proposed new regulatory requirements to address ethics in contracting since minimum standards already exist within the Department's regulations (§§3016.36(b)(3) and 3019.42).

Commenters that addressed the issue of procurement ethics were unanimous that FNS needs to undertake additional efforts in this area. Commenters also supported the need for additional efforts by FNS to address long term beverage contracting issues. Some of these commenters were specific about ethical issues in the procurement of long term

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beverage and food service management contracts, while others addressed the ethics issue on a broader scale. One commenter requested that the final regulations prohibit contractors from offering incentive payments or providing payments in advance of contract execution since such payments could subvert full and open competition. We do not disagree with the commenter that an inducement to contract conflicts with full and open competition. However, because we did not propose to issue regulations addressing ethics at this time, it would be inappropriate for us to do so in a final rulemaking. Further, pursuant to the Department regulations, school food authorities are currently required to have a written code of conduct that prohibits unethical actions in the procurement process. Finally, all school food authorities are required by Department regulations to have procedures in place to respond to protests and disputes of aggrieved bidders. Another commenter recommended that FNS require State agencies and school food authorities to obtain written financial interest statements from potential consultants which would require these consultants to disclose possible conflicts of interest before engaging in consulting and technical assistance efforts. Again, while we agree such statements represent good business practice, it would be inappropriate at this time for us to issue final regulations requiring such statements. However, as mentioned under Training and Technical Assistance, we will be conducting training on this regulation. We provide information on contracting ethics in that training. Given the concerns and comments received on the issue of ethics in contracting, we have determined it is appropriate to include a reference to its existing ethics and integrity requirements at §§210.21(c), 215.14a and 220.16(c). FNS will continue to monitor procurement ethics

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and integrity as this regulation is implemented and will evaluate what additional actions are needed to address these issues.

N. Implementation

We also received comments on implementation timeframes for a final rulemaking. Some of the commenters requested a moratorium on implementation for existing food service management company contracts until after all contract renewals had been completed. These commenters viewed the one year term of a food service management company contract with up to four additional one year renewals as a single contract. That is not correct. Food service management company contracts are one year in duration. The decision to renew the contract is an affirmative decision by both parties. Generally each renewal period is accompanied by some change in the contract terms, usually related to the change in FNS' school meal reimbursement rates. We are also aware that some contracts contain a provision that results in renewal unless notification of nonrenewal is provided. This type of provision does not create a multi-year contract. One commenter requested a delay in implementation for existing food service management company contracts until school year 2008 which begins on July 1, 2007. Another commenter requested implementation over a period of time to permit an orderly process for school food authorities to develop appropriate procurement documents and
provide sufficient time for State agencies to review those documents.

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We recognize that, in some cases, immediate implementation of these regulatory changes would create an unreasonable burden on school food authorities, State agencies and contractors. However, delaying implementation for years is more unreasonable. In considering how best to implement the changes in procurements required under this final rulemaking, we have determined that there is no reason to delay implementation for procurements yet to be conducted, but consideration is needed for existing contracts taking into account the available renewal periods under those contracts and procurement solicitations that have been issued but not yet awarded as of the date this rulemaking is effective. We also agree that each State agency should have flexibility in establishing the implementation schedules within its own State.

In balancing the critical need for prompt implementation against these considerations, we have established the following implementation schedule:

1. The regulations will be applicable for all new procurements initiated 30 days after the date this regulation is published.

2. School food authorities and State agencies are exempt from applying the provisions of this rulemaking to contracts with a term of 12 or fewer months when the solicitation for the contract was issued prior to the effective date of this regulation.

3. With State agency approval, school food authorities with contracts that have annual renewal provisions may delay implementation until expiration of the current contract plus one 12-month renewal period when the solicitation for the current contract was issued prior to the effective date of this regulation.

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4. With State agency approval, school food authorities with contracts that have a term of more than 12 months (i.e., contracts with entities other than food service management companies) may delay implementation up to 24 months from the effective date of this regulation when the solicitation for the contract was issued prior to the effective date of this regulation.

The annual term of most school food authority food service management company contracts mirrors the July 1 – June 30 school year. This means that a school food authority that entered into the first year of its contract effective for the July 1, 2005-June 30, 2006 school year can, with State agency approval, renew the contract for the July 1, 2006-June 30, 2007 school year, but must conduct a new procurement that meets the requirements of these regulations for the school year that begins on July 1, 2007. State agencies are free to establish shorter time frames for implementation or may require some school food authorities to implement the requirements sooner than others. However, in no case may a school food authority be permitted to delay implementation beyond the timeframes specified above.

O. Miscellaneous comments

We received comments on a number of other subjects.

A number of commenters expressed opinions on the provision at §210.16(b)(1) which permits a food service management company to submit the 21-day menu and requires compliance with the menu for the first 21-days of food service operations. FNS was not

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proposing any changes to this provision but instead used the opportunity of the proposed rulemaking to restructure a cumbersome sentence. One commenter questioned our legal authority to issue the proposed regulation. The Secretary's authority to issue regulations is found at 42 U.S.C. 1779 which authorizes the Secretary to prescribe such regulations deemed necessary to carry out the provisions of the Child Nutrition Act of 1966 and the Richard B. Russell National School Lunch Act.

One commenter suggested clarifying that FNS regulations implement applicable OMB circulars at §210.21(a) and the deletion of the last sentence at §210.21(c). We agree and have amended §210.21(a) and (c) as well as the corresponding provisions at §§215.14a(a), 215.14(a)(c), 220.16(a) and 220.16(c) accordingly. Another commenter requested clarification of whether Department regulation 7 CFR part 3015 still applies to the FNS's school nutrition programs. While the majority of the Department's requirements that apply to the school nutrition programs have been moved from 7 CFR part 3015 into 7 CFR parts 3106 and 3019, some requirements, particularly those affecting the award of discretionary grants, acknowledgment on audio visual materials and procedures for prior approval of costs still remain in 7 CFR part 3015.

One commenter requested clarification that the prohibition at §3016.36(b) would not apply to winning bidders negotiating contract terms since conducting a procurement does not include post-procurement activities. While 7 CFR part 3016 was not the subject of the proposed rulemaking, we will take this opportunity to clarify the commenter's

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misunderstanding of what constitutes the procurement process. The procurement process includes all phases of the process from the initial determination that goods and services are needed until the conclusion of the record retention period following the termination of the contract period. While negotiating contract terms is acceptable, potential contractors are not permitted to draft contract terms and conditions. This position is consistent with the §§3016.36(b) and 3016.60(b), and the direction provided to FNS by the managers in Conference Report (105-786) accompanying the William F. Goodling Child Nutrition Reauthorization Act of 1998 (Public Law 105-336) (Goodling Act).

This same commenter also expressed concerns that under the Federalism principles it is inappropriate for the Department's Regional Offices to assist State agencies in the development and drafting of procurement documents. In expressing his concern with such assistance, the commenter cited the Conference report accompanying the Goodling Act which expresses the expectation that FNS promptly and fully address each instance in which federal authorities address a matter of subgrantee procurement. Responding to requests for assistance from State agencies does not conflict with the principles of Federalism, nor does providing assistance to State agencies in their development of procurement documents run counter to the report language cited, further such actions supports the more recent language given in the Conference Report 107-424 accompanying the Farm Security and Rural Investment Act of 2002 (Public Law 107-171). In that report, the managers made clear that school food authorities are still required to follow federal procurement rules calling for free and open competition. It is

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unreasonable to expect State agencies to develop appropriate procurement materials without access to FNS's resources concerning federal procurement rules.

FNS also received a number of other comments unrelated to the proposed rulemaking which are thus not addressed here.

II. Procedural Matters

A. Executive Order 12866

This rule has been determined to be significant and was reviewed by the Office Management and Budget in conformance with Executive Order 12866.

B. Regulatory Impact Analysis

Need for Action

This action is needed to remedy deficiencies in school food authority procurements that have been identified in audits and program reviews and make the procurement requirements and consequences for failing to take corrective action consistent in the National School Lunch, Special Milk and School Breakfast Programs.

Benefits

School food authorities will benefit from the provisions of this rule because they will better understand their responsibilities for conducting proper procurements and consequences for failing to conduct proper procurements. State agencies will have the

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authority to review school food authority procurement documents and procedures to identify deficiencies and obtain corrective action which will minimize the potential for the misuse of program funds. Competition will be enhanced because potential contactors will be provided with more specific information that will allow them to prepare more appropriate and competitive responses to school food authority solicitations.

Costs

Any increases in costs resulting from this final rule are expected to result from the contractor's allocation and records maintenance of rebates, discounts, and other applicable credits to school food authorities and the identification and reporting of allowable and unallowable costs. However, contractors already have accounting, reporting and records maintenance systems in place to track and report the costs that are billed to school food authorities. Further, under generally accepted accounting principles and good business practices, these contractors maintain systems to track and report rebates and discounts. For these reasons, it is not expected that contractors will incur a significant increase in costs due to these requirements. However, any additional costs incurred by contractors for implementing the provisions of these regulations would be part of the contractor's administrative expenses and could be included in the fixed fee component of a cost reimbursable contract.

C. Regulatory Flexibility Act_

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This rule has been reviewed with regard to the requirements of the Regulatory Flexibility Act (5 U.S.C. 601-612). Eric M. Bost, Under Secretary for Food, Nutrition and Consumer Services has certified that this rule will not have a significant economic impact on a substantial number of small entities. This rule will affect school food authorities, State agencies and cost reimbursable contractors. School food authorities will be required to limit the expenditure of nonprofit school food service account funds to the net allowable costs, while cost reimbursable contractors of school food authorities will be required to provide information to permit school food authorities to make this determination. State agencies will be required to review school food contracts. While the effect of this rule may require potential contractors, selected contractors and school food authorities to amend the bidding process and make adjustments to accountability activities during a contract period, these process changes will not have a significant economic impact on those small entities.

D. Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995 (UMRA), Public Law 104-4, establishes requirements for Federal agencies to assess the effects of their regulatory actions on State, local, and tribal governments and the private sector. Under Section 202 of the UMRA, FNS generally must prepare a written statement, including a cost/benefit analysis, for proposed and final rules with “Federal mandates” that may result in expenditures to State, local, or tribal governments in the aggregate, or to the private sector, of $100 million or more in any one year. When such a statement is needed for a

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rule, section 205 of the UMRA generally requires FNS to identify and consider a reasonable number of regulatory alternatives and adopt the least costly, more cost-effective or least burdensome alternative that achieves the objectives of the rule.

This rule contains no Federal mandates (under the regulatory provisions of Title II of the UMRA) that impose costs on State, local, or tribal governments or to the private sector of $100 million or more in any one year. This rule is, therefore, not subject to the requirements of sections 202 and 205 of the UMRA.

E. Executive Order 12372

The National School Lunch Program, Special Milk Program and the School Breakfast Program are listed in the Catalog of Federal Domestic Assistance under No. 10.555, 10.556, and 10.553, respectively. For the reasons set forth in the final rule in 7 CFR part 3015, Subpart V and related Notice (48 FR 29115, June 24, 1983), these programs are included in the scope of Executive Order 12372, which requires intergovernmental consultation with State and local officials.

F. Executive Order 13132

Executive Order 13132 requires Federal agencies to consider the impact of their regulatory actions on State and local governments. Where such actions have federalism implications, agencies are directed to provide a statement for inclusion in the preamble to the regulations describing the agency's considerations in terms of the three categories called for under section (6)(b)(2)(B) of Executive Order 13132. FNS has considered the

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impact of this rule on State and local governments and has determined that this rule does not have Federalism implications. This rule does not impose substantial or direct compliance costs on State and local governments. Therefore, under Section 6(b) of the Executive Order, a federalism summary impact statement is not required.

G. Executive Order 12988

This rule has been reviewed under Executive Order 12988, Civil Justice Reform. This rule is intended to have preemptive effect with respect to any State or local laws, regulations or policies which conflict with its provisions or which would otherwise impede its full implementation. This rule is not intended to have a retroactive effect unless so specified in the DATES paragraph of this preamble. Prior to any judicial challenge to the provisions of this rule or the application of its provisions, all applicable administrative procedures must be exhausted.

H. Civil Rights Impact Analysis

Under Department Regulation 4300-4, Civil Rights Impact Analysis, FNS has reviewed this final rule to identify and address any major civil rights impacts the final rule might have on minorities, women, and persons with disabilities. After a careful review of the rule’s intent and provisions, FNS has determined that this rule would not in any way limit or reduce participants’ ability to participate in the Child Nutrition Programs on the basis of an individual’s or group’s race, color, national origin, sex, age or disability.

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FNS found no factors that would negatively and disproportionately affect any group of individuals.

I. Paperwork Reduction Act_

The Paperwork Reduction Act of 1995 (44 U.S.C. Chap. 35; see 5 CFR 1320) requires that the Office of Management and Budget (OMB) approve all collections of information by a Federal agency before they can be implemented. Respondents are not required to respond to any collection of information unless it displays a current valid OMB control number. The information collection requirements contained in this rule are cleared under OMB Number 0584-XXXX. [This rule can not be published in the Federal Register until the information collection package is approved by OMB}.

J. Government Paperwork Elimination Act

FNS is committed to compliance with the Government Paperwork Elimination Act (GPEA), which requires Government agencies to provide the public the option of submitting information or transacting business electronically to the maximum extent possible.

List of Subjects

7 CFR Part 210

Grant programs–education, Grant programs–health, Infants, and children,

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Nutrition, Penalties, Reporting and recordkeeping requirements, School breakfast and lunch programs.

7 CFR Part 215

Food assistance programs, Grant programs-education, Grant programs-health, Infants and children, Milk, Reporting and recordkeeping requirements.

7 CFR Part 220

Grant programs–education, Grant programs–health, Infants, and children, Nutrition, Penalties, Reporting and recordkeeping requirements, School breakfast and lunch programs.

Accordingly, 7 CFR Parts 210, 215 and 220 are amended as follows:

PART 210 – NATIONAL SCHOOL LUNCH PROGRAM

1. The authority citation for Part 210 continues to read as follows:

Authority: 42 U.S.C. 1751-1760, 1779.

2. In §210.2, add, in alphabetical order, the definitions of "Applicable credits", "Contractor", "Cost reimbursable contract", "Fixed fee" and "Nonprofit school food service account" to read as follows:

§210.2 Definitions.

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*   *   *   *   *

Applicable credits shall have the meaning established in Office of Management and Budget Circulars A-87, C(4) and A-122, Attachment A, A(5), respectively. For availability of OMB circulars referenced in this definition see 5 CFR 1310.3.

*   *   *   *   *

Contractor means a commercial enterprise, public or nonprofit private organization or individual that enters into a contract with a school food authority.

Cost reimbursable contract means a contract that provides for payment of incurred costs to the extent prescribed in the contract, with or without a fixed fee.

*   *   *   *   *

Fixed fee means an agreed upon amount that is fixed at the inception of the contract. In a cost reimbursable contract, the fixed fee includes the contractor's direct and indirect administrative costs and profit allocable to the contract.

*   *   *   *   *

Nonprofit school food service account means the restricted account in which all of the revenue from all food service operations conducted by the school food authority principally for the benefit of school children is retained and used only for the operation or improvement of the nonprofit school food service.

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3. In §210.16:

a. Amend paragraph (a)(7) by removing the word “and” at the end of the paragraph;

b. Amend paragraph (a)(8) by removing the period at the end of the paragraph and adding a semicolon in its place;

c. Add paragraphs (a)(9) and (a)(10) at the end; and

d. Amend paragraph (b)(1) by removing the second sentence and adding a new sentence in its place.

The additions read as follows:

§210.16 Food service management companies.

(a) ***

(9) Obtain written approval of invitations for bids and requests for proposals before their issuance when required by the State agency. The school food authority must incorporate all State agency required changes to its solicitation documents before issuing those documents; and

(10) Ensure that the State agency has reviewed and approved the contract terms and the school food authority has incorporated all State agency required changes into the contract or amendment before any contract or amendment to an existing food service management company contract is executed. Any changes made by the school food authority or a food service management company to a State agency pre-approved prototype contract or State

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agency approved contract term must be approved in writing by the State agency before the contract is executed. When requested, the school food authority must submit all procurement documents, including responses submitted by potential contractors, to the State agency, by the due date established by the State agency.

(b) * * *

(1) * * * A school food authority with no capability to prepare a cycle menu may, with State agency approval, require that each food service management company include a 21-day cycle menu, developed in accordance with the provisions of §210.10, with its bid or proposal. * * *

* * * * *

4. In §210.19:

a. Amend paragraph (a)(2) by adding two new sentences between sentences two and three; and

b. Amend paragraph (a)(6) by removing the first sentence and adding four new sentences in its place.

The additions read as follows:

§210.19 Additional responsibilities.

(a) * * *

(2) * * * All costs resulting from contracts that do not meet the requirements of this part are unallowable nonprofit school food service account expenses. When the school food

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authority fails to incorporate State agency required changes to solicitation or contract documents, all costs resulting from the subsequent contract award are unallowable charges to the nonprofit school food service account. * * *

*   *   *   *   *

(6) * * * Each State agency shall annually review each contract between any school food authority and food service management company to ensure compliance with all the provisions and standards set forth in this part before execution of the contract by either party. When the State agency develops a prototype contract for use by the school food authority that meets the provisions and standards set forth in this part, this annual review may be limited to changes made to that contract. Each State agency shall review each contract amendment between a school food authority and food service management company to ensure compliance with all the provisions and standards set forth in this part before execution of the amended contract by either party. The State agency may establish due dates for submission of the contract or contract amendment documents. * * *

*   *   *   *   *

5. In §210.21:

a.   Revise paragraph (a);

b.   Revise paragraph (c); and

c.   Add a new paragraph (f).

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The revisions and addition read as follows:

§210.21 Procurement.

(a) General. State agencies and school food authorities shall comply with the requirements of this part and 7 CFR Part 3016 or 7 CFR Part 3019, as applicable, which implement the applicable Office of Management and Budget Circulars, concerning the procurement of all goods and services with nonprofit school food service account funds.

* * * * *

(c) Procedures. The State agency or school food authority may use its own procurement procedures which reflect applicable State and local laws and regulations, provided that procurements made with nonprofit school food service account funds adhere to the standards set forth in this part and §§3016.36(b) through 3016.36(i), 3016.60 and 3019.40 through 3019.48 of this title, as applicable, and in the applicable Office of Management and Budget Circulars. School food authority procedures must include a written code of standards of conduct meeting the minimum standards of §§3016.36(b)(3) or 3019.42 of this title, as applicable.

(1) Pre-issuance review requirement. The State agency may impose a pre-issuance review requirement on a school food authority's proposed procurement. The school food authority must make available, upon request of the State agency, its procurement documents, including but not limited to solicitation documents, specifications, evaluation criteria, procurement procedures, proposed contracts and contract terms. School food

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authorities shall comply with State agency requests for changes to procurement procedures and solicitation and contract documents to ensure that, to the State agency's satisfaction, such procedures and documents reflect applicable procurement and contract requirements and the requirements of this part.

(2) Prototype solicitation documents and contracts. The school food authority must obtain the State agency's prior written approval for any change made to prototype solicitation or contract documents before issuing the revised solicitation documents or execution of the revised contract.

(3) Prohibited expenditures. No expenditure may be made from the nonprofit school food service account for any cost resulting from a procurement failing to meet the requirements of this part.

* * * * *

(f) Cost reimbursable contracts. (1) Required provisions. The school food authority must include the following provisions in all cost reimbursable contracts, including contracts with cost reimbursable provisions, and in solicitation documents prepared to obtain offers for such contracts:

(i) Allowable costs will be paid from the nonprofit school food service account to the contractor net of all discounts, rebates and other applicable credits accruing to or received by the contractor or any assignee under the contract, to the extent those credits are allocable to the allowable portion of the costs billed to the school food authority;

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(ii) (A)The contractor must separately identify for each cost submitted for payment to the school food authority the amount of that cost that is allowable (can be paid from the nonprofit school food service account) and the amount that is unallowable (cannot be paid from the nonprofit school food service account), or;

(B) The contractor must exclude all unallowable costs from its billing documents and certify that only allowable costs are submitted for payment and records have been established that maintain the visibility of unallowable costs, including directly associated costs in a manner suitable for contract cost determination and verification;

(iii) The contractor's determination of its allowable costs must be made in compliance with the applicable Departmental and Program regulations and Office of Management and Budget cost circulars;

(iv)The contractor must identify the amount of each discount, rebate and other applicable credit on bills and invoices presented to the school food authority for payment and individually identify the amount as a discount, rebate, or in the case of other applicable credits, the nature of the credit. If approved by the State agency, the school food authority may permit the contractor to report this information on a less frequent basis than monthly, but no less frequently than annually;

(v) The contractor must identify the method by which it will report discounts, rebates and other applicable credits allocable to the contract that are not reported prior to conclusion of the contract; and

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(vi)The contractor must maintain documentation of costs and discounts, rebates and other applicable credits, and must furnish such documentation upon request to the school food authority, the State agency, or the Department.

(2) Prohibited expenditures. No expenditure may be made from the nonprofit school food service account for any cost resulting from a cost reimbursable contract that fails to include the requirements of this section, nor may any expenditure be made from the nonprofit school food service account that permits or results in the contractor receiving payments in excess of the contractor's actual, net allowable costs.

§210.24 [Amended]

6. In §210.24, amend the first sentence by removing the words "7 CFR Part 3016 and 7 CFR Part 3019, as applicable" and adding in their place the words "Departmental regulations at §§3016.43 and 3019.62". -

PART 215 – SPECIAL MILK PROGRAM

1. The authority citation for Part 215 continues to read as follows:

Authority: 42 U.S.C. 1772 and 1779.

2. In §215.2, add paragraph (c), previously reserved, and paragraphs (e-3), (e-4), (e-5) and (r-1) to read as follows:

§215.2 Definitions.

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*   *   *   *   *

(c) Applicable credits shall have the meaning established in Office of Management and Budget Circulars A-87, C(4) and A-122, Attachment A, A(5), respectively. For availability of OMB circulars referenced in this definition, see 5 CFR 1310.3.

*   *   *   *   *

(e-3) Contractor means a commercial enterprise, public or nonprofit private organization or individual that enters into a contract with a school food authority.

(e-4) Cost reimbursable contract means a contract that provides for payment of incurred costs to the extent prescribed in the contract, with or without a fixed fee.

(e-5) Fixed fee means an agreed upon amount that is fixed at the inception of the contract. In a cost reimbursable contract, the fixed fee includes the contractor's direct and indirect administrative costs and profit allocable to the contract.

*   *   *   *   *

(r-1) Nonprofit school food service account means the restricted account in which all of the revenue from the nonprofit milk service maintained for the benefit of children is retained and used only for the operation or improvement of the nonprofit milk service.

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* * * * *

3. In §215.14a;

a. Revise paragraph (a);

b. Revise paragraph (c); and

c. Add a new paragraph (d).

The revisions and addition read as follows:

§215.14a Procurement standards.

(a) General. State agencies and school food authorities shall comply with the requirements of this part and parts 3015, 3016 and 3019 of this title, as applicable, which implement the applicable Office of Management and Budget Circulars, concerning the procurement of all goods and services with nonprofit school food service account funds.

* * * * *

(c) Procedures. The State agency or school food authority or child care institution may use its own procurement procedures which reflect applicable State or local laws and regulations, provided that procurements made with nonprofit school food service account funds adhere to the standards set forth in this part and §§3016.36(b) through 3016.36(i), 3016.60 and 3019.40 through 3019.48 of this title, as applicable, and in the applicable Office of Management and Budget Circulars. School food authority procedures must

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include a written code of standards of conduct meeting the minimum standards of §§3016.36(b)(3) or 3019.42 of this title, as applicable.

(1) Pre-issuance review requirement. The State agency may impose a pre-issuance review requirement on a school food authority's proposed procurement. The school food authority must make available, upon request of the State agency, its procurement documents, including but not limited to solicitation documents, specifications, evaluation criteria, procurement procedures, proposed contracts and contract terms. School food authorities shall comply with State agency requests for changes to procurement procedures and solicitation and contract documents to ensure that, to the State agency's satisfaction, such procedures and documents reflect applicable procurement and contract requirements and the requirements of this part.

(2) Prototype solicitation documents and contracts. The school food authority must obtain the State agency's prior written approval for any change made to prototype solicitation or contract documents before issuing the revised solicitation documents or execution of the revised contract.

(3) Prohibited expenditures. No expenditure may be made from the nonprofit school food service account for any cost resulting from a procurement failing to meet the requirements of this part.

(d) Cost reimbursable contracts. (1) Required provisions. The school food authority must include the following provisions in all cost reimbursable contracts, including

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contracts with cost reimbursable provisions, and in solicitation documents prepared to obtain offers for such contracts:

(i) Allowable costs will be paid from the nonprofit school food service account to the contractor net of all discounts, rebates and other applicable credits accruing to or received by the contractor or any assignee under the contract, to the extent those credits are allocable to the allowable portion of the costs billed to the school food authority;

(ii)(A) The contractor must separately identify for each cost submitted for payment to the school food authority the amount of that cost that is allowable (can be paid from the nonprofit school food service account) and the amount that is unallowable (cannot be paid from the nonprofit school food service account), or;

(B) The contractor must exclude all unallowable costs from its billing documents and certify that only allowable costs are submitted for payment and records have been established that maintain the visibility of unallowable costs, including directly associated costs in a manner suitable for contract cost determination and verification;

(iii) The contractor's determination of its allowable costs must be made in compliance with the applicable Departmental and Program regulations and Office of Management and Budget cost circulars;

(iv) The contractor must identify the amount of each discount, rebate and other applicable credit on bills and invoices presented to the school food authority for payment and identify the amount as a discount, rebate, or in the case of other applicable credits, the nature of the credit. If approved by the State agency, the school food authority may

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permit the contractor to report this information on a less frequent basis than monthly, but no less frequently than annually;

(v) The contractor must identify the method by which it will report discounts, rebates and other applicable credits allocable to the contract that are not reported prior to conclusion of the contract; and

(vi) The contractor must maintain documentation of costs and discounts, rebates and other applicable credits, and must furnish such documentation upon request to the school food authority, the State agency, or the Department.

(2) Prohibited expenditures. No expenditure may be made from the nonprofit school food service account for any cost resulting from a cost reimbursable contract that fails to include the requirements of this section, nor may any expenditure be made from the nonprofit school food service account that permits or results in the contractor receiving payments in excess of the contractor's actual, net allowable costs.

4. Redesignate §§215.15 through 215.17 as §§215.16 through 215.18, respectively; and add a new §215.15 to read as follows:

§215.15 Withholding payments.

In accordance with Departmental regulations at §§3016.43 and 3019.62 of this title, the State agency shall withhold Program payments in whole or in part, to any school food authority which has failed to comply with the provisions of this part. Program payments shall be withheld until the school food authority takes corrective action satisfactory to the

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State agency, or gives evidence that such corrective actions will be taken, or until the State agency terminates the grant in accordance with §215.16. Subsequent to the State agency's acceptance of the corrective actions, payments will be released for any milk served in accordance with the provisions of this part during the period the payments were withheld.

PART 220 – SCHOOL BREAKFAST PROGRAM

1. The authority citation for Part 220 continues to read as follows:

Authority: 42 U.S.C. 1773, 1779, unless otherwise noted.

2. In §220.2, add paragraphs (a-1), (d-1), (d-2), (g-1) and (o-3) to read as follows:

§220.2 Definitions.

*   *   *   *   *

(a-1) Applicable credits shall have the meaning established in Office of Management and Budget Circulars A-87, C(4) and A-122, Attachment A, A(5), respectively. For availability of OMB circulars referenced in this definition see 5 CFR 1310.3.

*   *   *   *   *

(d-1) Contractor means a commercial enterprise, public or nonprofit private organization or individual that enters into a contract with a school food authority.

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(d-2) Cost reimbursable contract means a contract that provides for payment of incurred costs to the extent prescribed in the contract, with or without a fixed fee.

* * * * *

(g-1) Fixed fee means an agreed upon amount that is fixed at the inception of the contract. In a cost reimbursable contract, the fixed fee includes the contractor's direct and indirect administrative costs and profit allocable to the contract.

* * * * *

(o-3) Nonprofit school food service account means the restricted account in which all of the revenue from all food service operations conducted by the school food authority principally for the benefit of school children is retained and used only for the operation or improvement of the nonprofit school food service.

* * * * *

3. In §220.7, revise paragraph (d) to read as follows:

§220.7 Requirements for participation.

* * * * *

(d)(1) Any school food authority (including a State agency acting in the capacity of a school food authority) may contract with a food service management company to manage its food service operation in one or more of its schools. However, no school or school

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food authority may contract with a food service management company to operate an a la carte food service unless the company agrees to offer free, reduced price and paid reimbursable breakfasts to all eligible children. Any school food authority that employs a food service management company in the operation of its nonprofit school food service shall:

(i) Adhere to the procurement standards specified in §220.16 when contracting with the food service management company;

(ii) Ensure that the food service operation is in conformance with the school food authority's agreement under the Program;

(iii) Monitor the food service operation through periodic on-site visits;

(iv) Retain control of the quality, extent, and general nature of its food service, and the prices to be charged the children for meals;

(v) Retain signature authority on the State agency-school food authority agreement, free and reduced price policy statement and claims;

(vi) Ensure that all federally donated foods received by the school food authority and made available to the food service management company accrue only to the benefit of the school food authority's nonprofit school food service and are fully utilized therein;

(vii) Maintain applicable health certification and assure that all State and local regulations are being met by a food service management company preparing or serving meals at a school food authority facility;

(viii) Obtain written approval of invitations for bids and requests for proposals before their issuance when required by the State agency. The school food authority must

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incorporate all State agency required changes to its solicitation documents before issuing those documents; and

(ix) Ensure that the State agency has reviewed and approved the contract terms and the school food authority has incorporated all State agency required changes into the contract or amendment before any contract or amendment to an existing food service management company contract is executed. Any changes made by the school food authority or a food service management company to a State agency pre-approved prototype contract or State agency approved contract term must be approved in writing by the State agency before the contract is executed. When requested, the school food authority must submit all procurement documents, including responses submitted by potential contractors, to the State agency, by the due date established by the State agency.

(2) In addition to adhering to the procurement standards under this part, school food authorities contracting with food service management companies shall ensure that:

(i) The invitation to bid or request for proposal contains a 21-day cycle menu developed in accordance with the provisions of §220.8, to be used as a standard for the purpose of basing bids or estimating average cost per meal. A school food authority with no capability to prepare a cycle menu may, with State agency approval, require that each food service management company include a 21-day cycle menu, developed in accordance with the provisions of §220.8, with its bid or proposal. The food service management company must adhere to the cycle for the first 21 days of meal service. Changes thereafter may be made with the approval of the school food authority; and

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(ii) Any invitation to bid or request for proposal indicate that nonperformance subjects the food service management company to specified sanctions in instances where the food service management company violates or breaches contract terms. The school food authority shall indicate these sanctions in accordance with the procurement provisions stated in §220.16.

(3) Contracts that permit all income and expenses to accrue to the food service management company and ‘‘cost-plus-a-percentage-of-cost’’ and ‘‘cost-plus-a-percentage-of-income’’ contracts are prohibited. Contracts that provide for fixed fees such as those that provide for management fees established on a per meal basis are allowed. Contractual agreements with food service management companies shall include provisions which ensure that the requirements of this section are met. Such agreements shall also include the following requirements:

(i) The food service management company shall maintain such records as the school food authority will need to support its Claim for Reimbursement under this part, and shall, at a minimum, report claim information to the school food authority promptly at the end of each month. Such records shall be made available to the school food authority, upon request, and shall be available for a period of 3 years from the date of the submission of the final Financial Status Report, for inspection and audit by representatives of the State agency, of the Department, and of the Government Accountability Office at any reasonable time and place. If audit findings have not been resolved, the records shall be retained beyond the three-year period (as long as required for the resolution of the issues raised by the audit);

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(ii) The food service management company shall have State or local health certification for any facility outside the school in which it proposes to prepare meals and the food service management company shall maintain this health certification for the duration of the contract; and

(iii) No payment is to be made for meals that are spoiled or unwholesome at time of delivery, do not meet detailed specifications as developed by the school food authority for each food component specified in §220.8, or do not otherwise meet the requirements of the contract. Specifications shall cover items such a grade, purchase units, style, condition, weight, ingredients, formulations, and delivery time.

(4) The contract between a school food authority and food service management company shall be of a duration of no longer than 1 year and options for the yearly renewal of the contract shall not exceed 4 additional years. All contracts shall include a termination clause whereby either party may cancel for cause with 60-day notification.

* * * * *

4. In §220.16,

a. Revise paragraph (a);

b. Amend paragraph (b) by removing the words “OMB Circular A-102 and 7 CFR 3015” and adding in their place the words “this part and parts 3015, 3016 and 3019 of this title, as applicable”;

d. Revise paragraph (c); and

e. Add a new paragraph (e).

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The revisions and addition read as follows:

§220.16 Procurement standards.

(a) General. State agencies and school food authorities shall comply with the requirements of this part and parts 3015, 3016 and 3019 of this title, as applicable, which implement the applicable Office of Management and Budget Circulars, concerning the procurement of all goods and services with nonprofit school food service account funds.

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(c) Procedures. The State agency or school food authority may use its own procurement procedures which reflect applicable State and local laws and regulations, provided that procurements made with nonprofit school food service account funds adhere to the standards set forth in this part and §§3016.36(b) through 3016.36(i), 3016.60 and 3019.40 through 3019.48 of this title, as applicable, and the applicable Office of Management and Budget Circulars. School food authority procedures must include a written code of standards of conduct meeting the minimum standards of §§3016.36(b)(3) or 3019.42 of this title, as applicable.

(1) Pre-issuance review requirement. The State agency may impose a pre-issuance review requirement on a school food authority's proposed procurement. The school food authority must make available, upon request of the State agency, its procurement documents, including but not limited to solicitation documents, specifications, evaluation criteria, procurement procedures, proposed contracts and contract terms. School food authorities shall comply with State agency requests for changes to procurement

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procedures and solicitation and contract documents to ensure that, to the State agency's satisfaction, such procedures and documents reflect applicable procurement and contract requirements and the requirements of this part.

(2) Prototype solicitation documents and contracts. The school food authority must obtain the State agency's prior written approval for any change made to prototype solicitation or contract documents before issuing the revised solicitation documents or execution of the revised contract.

(3) Prohibited expenditures. No expenditure may be made from the nonprofit school food service account for any cost resulting from a procurement failing to meet the requirements of this part.

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(e) Cost reimbursable contracts. (1) Required provisions. The school food authority must include the following provisions in all cost reimbursable contracts, including contracts with cost reimbursable provisions, and in solicitation documents prepared to obtain offers for such contracts:

(i) Allowable costs will be paid from the nonprofit school food service account to the contractor net of all discounts, rebates and other applicable credits accruing to or received by the contractor or any assignee under the contract, to the extent those credits are allocable to the allowable portion of the costs billed to the school food authority;

(ii)(A) The contractor must separately identify for each cost submitted for payment to the school food authority the amount of that cost that is allowable (can be paid from the

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nonprofit school food service account) and the amount that is unallowable (cannot be paid from the nonprofit school food service account), or;

(B) The contractor must exclude all unallowable costs from its billing documents and certify that only allowable costs are submitted for payment and records have been established that maintain the visibility of unallowable costs, including directly associated costs in a manner suitable for contract cost determination and verification;

(iii) The contractor's determination of its allowable costs must be made in compliance with the applicable Departmental and Program regulations and Office of Management and Budget cost circulars;

(iv) The contractor must identify the amount of each discount, rebate and other applicable credit on bills and invoices presented to the school food authority for payment and identify the amount as a discount, rebate, or in the case of other applicable credits, the nature of the credit. If approved by the State agency, the school food authority may permit the contractor to report this information on a less frequent basis than monthly, but no less frequently than annually;

(v) The contractor must identify the method by which it will report discounts, rebates and other applicable credits allocable to the contract that are not reported prior to conclusion of the contract; and

(vi) The contractor must maintain documentation of costs and discounts, rebates, and other applicable credits, and must furnish such documentation upon request to the school food authority, the State agency, or the Department.

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(2) Prohibited expenditures. No expenditure may be made from the nonprofit school food service account for any cost resulting from a cost reimbursable contract that fails to include the requirements of this section, nor may any expenditure be made from the nonprofit school food service account that permits or results in the contractor receiving payments in excess of the contractor's actual, net allowable costs.

4. Redesignate §§220.18 through 220.21 as §§220.19 through 220.22, respectively; and add a new §220.18 to read as follows:

§220.18 Withholding payments.

In accordance with Departmental regulations at §§3016.43 and 3019.62 of this title, the State agency shall withhold Program payments, in whole or in part, to any school food authority which has failed to comply with the provisions of this part. Program payments shall be withheld until the school food authority takes corrective action satisfactory to the State agency, or gives evidence that such corrective actions will be taken, or until the State agency terminates the grant in accordance with §220.19. Subsequent to the State agency's acceptance of the corrective actions, payments will be released for any breakfasts served in accordance with the provisions of this part during the period the payments were withheld.

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Eric M. Bost
Under Secretary for Food, Nutrition and
Consumer Services

Date

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