UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C. 20460

JUN - 5 2014

THE INSPECTOR GENERAL

MEMORANDUM

SUBJECT: Resolution of Office of Inspector General Report No. 13-P-0209, *Opportunities for EPA-Wide Improvements Identified During Review of a Time and Materials Contract,* Issued April 4, 2013

FROM: Arthur A. Elkins Jr. AE (for CJS)

TO: Bob Perciasepe, Deputy Administrator

This memorandum relates to the final dispute resolution meeting held on May 29, 2014. We told you at the meeting that we would send you a follow-up document. We hope this brief discussion about a few key points raised at the meeting will be of use to you in your decision-making.

First, the U.S. Environmental Protection Agency (EPA) focused at the meeting largely on its argument that the profit on materials paid under the contract was a harmless error because the contracting officer's intent was to achieve a different effect. This issue has not been addressed directly in prior Office of Inspector General (OIG) legal statements. In the past, however, we have found the information relating to this argument to be confusing and inaccurate. For example, the agency contends that the contracting officer intended that the profit paid on materials was really meant to be additional profit on labor.[1] However, when we interviewed the now retired contracting officer, he stated that he did not even consider the 4 percent payment to be profit; yet his September 2008 written justification for reducing the 10 percent initially requested by the contractor to 4 percent was justified in accordance with an agency profit/fee clause (EPA Acquisition Regulation [EPAAR] Subsection 1515.404-471). Hence, the contracting officer's real intent is in question. An additional problem with the resort to "intent" relates to the agency position that the profit on materials paid to the prime contractor was needed to offset additional risk encountered in a construction management/oversight contract. This appears to be factually incorrect because the government actually bears all the risk in a time and materials contract given that it is paying for all charged management/oversight. The 4 percent profit on materials – not only violated the Federal Acquisition Regulation (FAR) – it was not justified.

[1] There was some confusion at the meeting about whether to say the FAR prohibits profit versus "additional" profit in a time and materials contract. To correct any misunderstanding, the FAR allows for payment of profit on labor but prohibits payment of profit on materials in a time and materials contract.

There is a long-standing principle in government contracting prohibiting the payment of profit on materials in a time and materials contract. That principle was codified in 2007 in FAR 52.232-7. The FAR Councils, in legislative history (cited in prior OIG legal statements), stated that the intent behind the prohibition is to avoid paying double profit given that all profit is negotiated as part of the labor rate. The 1984 EPAAR clause that was included in the contract was outdated and did not include the FAR 2007 prohibition on paying profit on materials. The agency seems to be refusing to acknowledge that it failed to update its EPAAR clause and that, after 2007, the old EPAAR clause should not have been in use.

In the end, however, information about any intention underlying the contract may well be irrelevant. In this case, a seasoned contracting officer and a large, sophisticated government contractor entered into a contract that failed to include a FAR clause that was required by law. The contracting officer and contractor then proceeded to include contractual terms that clearly violated a long-standing government contracting principle and a codification of the principle in the form of the FAR clause that stated the government "will not" – except for a narrow exception that is not relevant here[2] – pay profit on materials in a time and materials contract. The clear terms of the contract violated a FAR regulation, and that fact cannot be ignored or justified away.[3] Using extrinsic evidence of the meaning of a contract, such as attempting to construe the intent behind contractual language, typically is relevant only if there is ambiguity in contractual terms. There was no ambiguity in the contractual terms at issue here.

Second, the EPA Office of General Counsel introduced a new legal argument at the meeting. This argument was not presented in written form, nor was it accompanied by legal support. Essentially, the Office of General Counsel appears to be arguing that FAR 32.111(a) – which requires agencies to include the FAR 52.232-7 clause when a time and materials contract is contemplated – gives EPA authority to use agency regulations to override the FAR clause requirement. This interpretation supposedly derives from language in FAR 32.111(a) that states "[t]he contracting officer shall insert the following clauses, appropriately modified with respect to payment due dates, **in accordance with agency regulations** (highlight added)." That interpretation of the FAR cannot be correct.[4] The FAR was intended to be the primary set of contracting regulations for the entirety of the federal government. The FAR allows for some supplementation related to specific agency needs, but FAR 1.304(b)(2) makes it very clear that agency regulations, except as required by law or when a deviation is authorized, "shall not" conflict or be inconsistent with FAR content.[5] Given the clear position of the FAR, the language in bold above could not be interpreted to mean that the agency could choose to ignore a requisite FAR clause prohibiting profit on materials in a time and materials contract in favor of an outdated EPAAR clause that contradicted the FAR by not requiring the prohibition. Also, the FAR would not state "shall" and then contradict itself a few words later with a phrase that is to be interpreted to mean, "but only if the agency so chooses."

Rather, the actual meaning of the language in bold above can be found in the words themselves. FAR 32.111(a) states that the clauses (which "shall" be inserted) can be modified "with respect to payment due dates." The payment due dates, and not compliance with the requirement, are to be set "in accordance with agency regulations." The meaning here is even more clear when one reviews the almost identical language in Sections 32.111(b) and (c): "The contracting officer shall insert the following

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[2] The exception is provided for in FAR Subsections 31.205-26(e) and (f). It states that materials, supplies, and services that are sold or transferred between any divisions, subsidiaries, or affiliates of the contractor under a common control may be adjusted for income and other credits, et al. There is no evidence that the materials in question here fall under this exception.

[3] Agency efforts to argue that even if the requisite FAR clause had been included it would not be applicable to the CH2M Hill contract because the subcontracted work does not fit the FAR definition of materials have failed. See, in detail, Attachments D and E to the April 10, 2014, memorandum that was sent to you.

[4] We did not locate any case law that attempted to interpret the effect of the language included in bold above. Presumably, the reason for that is because the language is not meant to exempt agencies from requisite contract clauses.

[5] At an earlier point in the legal discussion, the agency suggested that it had a class deviation for the EPAAR clause in question here. There was no written support for the existence of a class deviation. The agency contended that the fact that the 1984 clause had effectively supplemented the FAR and that it had been amended as late as 2002 in and of itself functions as evidence of a class deviation from the FAR clause at 52.232-7. In response, the OIG queried how an EPAAR clause that significantly predated the 2007 FAR clause with its prohibition on payment of profit on materials could possibly constitute a deviation from the later FAR clause; in short, how can one deviate from something that is not yet in existence? Also, why would the agency seek a class deviation from a prohibition designed to keep the government from paying double profit? The agency has not responded to the OIG positions.

clauses, appropriately modified with respect to payment due dates in accordance with agency regulations: ...." In sections (b) and (c) the comma following "due dates" does not exist and so the meaning is more obvious; the due dates are to be set in accordance with agency regulations. The language does not give EPA the asserted freedom to do whatever it wants with the requisite clauses. Given this is the first time the argument has been raised, it most certainly was not a position held by the contracting officer at the time he crafted the contract.

Third, and finally, at the outset of the meeting the agency promised that the problems found in the contract, awarded on September 24, 2008, will not occur again. A major problem in the contract identified by the OIG is that it did not include a clause that is required by the FAR. So, this begs a question: Will all future time and materials contracts entered into by the EPA include the requisite FAR clause that prohibits the government from paying profit on materials (Section 52.232-7)? (Indeed, we located a Region 5 time and materials contract, awarded in 2013, that included the requisite FAR clause prohibiting profit on materials.) If future contracts of the time and materials type will include the legally required clause, then the agency arguments that the clause was not required in the 2008 contract in question here seemingly fall. Conversely, if the agency has now decided that it does not have to include the FAR clause in question in time and materials contracts, then it will have to explain why it has decided to intentionally violate the FAR.

After numerous written and oral arguments, the agency to date has not forwarded one persuasive factual or legal argument that would cause the OIG to abandon its position that the agency violated the FAR and that violation resulted in a $1.5-million-plus overpayment to a contractor. We repeat our recommendation that the EPA modify the contract to remove the 4 percent profit clause and that it recover the wrongful payment.

In line with past practice, this memorandum and the memorandum (plus attachments) sent to you on April 10, 2014, will immediately be made public on our website. Your decision will be added to the website.

If you have any questions regarding this memorandum, please contact Carolyn Copper, Assistant Inspector General for Program Evaluation, at (202) 566-0829 or carolyn.copper@epa.gov; or Eric Lewis, Director, Special Program Reviews, at (202) 566-2664 or lewis.eric@epa.gov.

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