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Commercial Items

View From RJO: The Challenge Of Pricing 'Commercial' Items

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Federal procurement changed fundamentally in 1994 with the enactment of the Federal Acquisition Streamlining Act. FASA established a statutory preference for acquisition of commercial items and relieved commercial suppliers of many costly regulatory burdens. FAR 15.4031(c)(3) exempts the acquisition of ''commercial items'' from the requirements for ''certified cost or pricing data'' under the Truth in Negotiations Act (TINA). Compliance with TINA imposes recurring record-keeping and accounting obligations without counterpart in the commercial world and exposes commercial companies to audit and oversight and other liabilities. Market competition for commercial items was thought to provide assurance of reasonable prices, obviating need for the burdens of TINA.

Since FASA's enactment, commercial items increasingly occupy a large portion of federal acquisition. Federal agencies spent $90 billion in 2011 on new awards for commercial items and services. Questions remain as to whether the ''commercial item'' classification provides adequate assurance of fair and reasonable pricing.

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Elasticity in the Crucial Definition. ''Commercial item'' is defined in statute, at 41 U.S.C. § 103, and in corresponding regulations, at FAR 2.101. Three words employed in the definitions – ''*of a type*'' – introduce elasticity in the definition that generates uncertainty and controversy. Industry has exploited this elasticity; DOD, especially, believes it has been abused.

The FAR defines ''commercial items'' as, ''[a]ny item . . . that is *of a type* customarily used by the general public . . . and has been sold, leased, or licensed to the general public; or has been offered for sale, lease, or license to the general public.'' FAR 2.101 (emphasis added). These items may be subject to modification ''*of a type* customarily available in the commercial marketplace,'' or ''[m]inor modifications *of a type* not customarily available in the commercial marketplace made to meet Federal Government requirements.'' *Id.* (emphasis added). Services are commercial items where they are, ''[s]ervices *of a type* offered and sold competitively in substantial quantities in the commercial marketplace based on established catalog or market prices for specific tasks performed or specific outcomes to be achieved and under standard commercial terms and conditions.'' *Id.* (emphasis added).

As applied in practice, the words ''of a type'' have meant that ''commercial item'' status can be maintained

even if the product or service has never actually been sold to the general public. Making the ''of a type'' decision is inherently judgmental, thus increasing opportunity for erroneous decision or abuse. Should the reach of ''of a type'' be constrained, fewer supplies, modifications and services will qualify as ''commercial'' items.

The Government's Concerns. DOD has been criticized for paying high prices for items that arguably are not ''commercial.'' The DOD IG criticized the Air Force, in 2006, for a $860 million non-competitive contract for F-16 parts that relied upon ''questionable commercial item determinations that exempted [the vendor] from the requirement to submit cost and pricing data.'' Department of Defense D-2006-122 (Sept. 29, 2006). Concluding that the contract produced ''excessive profit'' in the range of $155 million to $206 million, the IG cited ''confusing'' guidance on commercial items as a source of the problem.

GAO also has been critical of commercial item classification. In a 2006 report, GAO observed:

> misclassification of items as commercial can leave DOD vulnerable to accepting prices that are not the best value for the department. . . . [I]f DOD designates an item as being a commercial item when it is not readily available in the commercial market, DOD limits its ability to assess the reasonableness of the contractor's price because it might have less information on prices to make its decision.

GAO-06-838R (July 7, 2006). Sometimes, DOD is a willing participant in contracting decisions to use ''commercial item'' techniques instead of other, more appropriate methods. GAO also has criticized DOD for failure to ''use other available information and techniques to determine price reasonableness and conduct price negotiations.''

Responses Pursued by the Government. Stung by these criticisms, DOD has committed to ''re-energize the cost analysis and price analysis functions within the department in response to these findings.'' D-2006-122, at 84. DOD has communicated concerns with the fairness of pricing on some ''commercial item'' purchases. Contracting Officers are frustrated with claims from companies, not normally thought of as commercial, who assert ''of a type'' services or products, leaving DOD unable to substantiate whether it is paying a reasonable price.

Consequently, in 2012 DOD sought to amend to the fiscal year 2013 Defense Authorization Act to *eliminate* the ''of a type'' language from the underlying statute (and thus from the corresponding FAR definitions). DOD's effort failed. Congress was concerned that the proposed change would limit DOD's access to ''fast moving commercial markets, including the markets for information technology and other advanced products.'' S. Rep. 112-173 at 143-44 (June 4, 2012).

After this legislative defeat, DOD instead directed acquisition officials to demand more information to justify proposed prices for commercial items. When there are no commercial sales or insufficient sales for an item, contracting officers are to require ''other than certified cost/pricing information'' to assist in making the determination of fair and reasonable pricing.''

DOD's intended focus may have been on a small group of companies it perceives as having abused the ''commercial item'' classification to overcharge DOD. These are likely to be tier 1 and 2 suppliers who have systems and procedures in place to comply with TINA. The hazard of DOD's new initiatives is that they also will affect a host of commercial companies who do not have these costly compliance systems in place. That's why DOD's commercial item pricing initiatives cause great concern across the diverse base of truly commercial companies who support DOD's needs.

Using Tools Already Available. DOD can address abuse of the ''commercial item'' classification without damaging the structure (and value) of FASA or burdening its commercial supplier base with costly obligations.

When price justification is needed, under the FAR agencies can require ''data other than certified cost or pricing data.'' This may include ''sales data and any information reasonably required to explain the offeror's estimating process, including, but not limited to, ''[t]he judgmental factors applied and the mathematical or other methods used in the estimate, including those used in projecting from known data; and [t]he nature and amount of any contingencies included in the proposed price.'' FAR §§ 2.101, 13.106–3, 14.408–2; FAR Part 15.4.

With respect to ''data other than certified cost or pricing data,'' a key distinction is between *price* data and *cost* data. The former may be derived from catalogs, market pricing, volume of sales, or other evidence of prices charged. The latter, because it focuses on individual cost elements and reveals a source's suppliers and costs of supply, is much more difficult to produce. More importantly, it represents *critical, competition-sensitive, proprietary information*. Commercial companies are ill-equipped and understandably loath to provide cost data where comparable requirements do not exist outside government markets.

While its concerns should not be ignored, DOD should avoid ''corrections'' that produce unintended consequences, especially in light of the recent judgment of Congress that DOD should not injure its access to commercial markets. DOD can be more discriminating in acquisition planning and can use competitive acquisition methods to avoid funding sole-source ''commercial item'' procurements. This would help ensure that supplies, modification or services are ''of a type'' that merit ''commercial item'' classification.

When it needs information, DOD should adhere to the information hierarchy mandated in FAR 15.402, focusing first on data available within the government and from other sources before requesting data from contractors. FAR § 12.209 mandates the use of the price reasonableness procedures set forth in FAR Subpart 15.4. DOD should ask for ''other than certified cost or pricing data'' only where it is needed after utilization of other techniques. It should confine and narrowly tailor such requests to *pricing* data, wherever possible. Only in exceptional situations should DOD request *cost*-based data because of potentially unachievable and unacceptable implications for many commercial sources. This accords with the DOD's own published guidance concerning the sequence of price and cost analysis. DFARS Procedures, Guidance, and Information, at PGI 215.4, indicate that *cost* analysis is to proceed only when the contracting officer ''cannot obtain sufficient data to perform a price analysis.'' DOD's Contract Attorneys Deskbook provides, at 12-4, that necessary information should be obtained ''in the least burdensome manner possible.'' Further, this should satisfy the underlying concern which led DOD to seek the statutory

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change to ''of a type'' because these procedures have been designed to allow contracting officers to determine that prices are fair and reasonable.

No change is needed to statute or regulation to deal with government concerns about the validity of ''commercial item'' classification or the fairness of pricing. Other means are available to address these concerns without alternation to FASA or risk to its purposes. At the same time, industry should take care not to demand that government customers accept as ''commercial items'' supplies or services with too tenuous a connection to real commercial markets and prices that invite scrutiny or suspicion.