

JOSEPH I. LIEBERMAN, CONNECTICUT, CHAIRMAN

CARL LEVIN, MICHIGAN
DANIEL K. AKAKA, HAWAII
THOMAS R. CARPER, DELAWARE
MARK L. PRYOR, ARKANSAS
MARY L. LANDRIEU, LOUISIANA
CLAIRE McCASKILL, MISSOURI
JON TESTER, MONTANA
MARK BEGICH, ALASKA

SUSAN M. COLLINS, MAINE
TOM COBURN, OKLAHOMA
SCOTT P. BROWN, MASSACHUSETTS
JOHN McCAIN, ARIZONA
RON JOHNSON, WISCONSIN
ROB PORTMAN, OHIO
RAND PAUL, KENTUCKY
JERRY MORAN, KANSAS

United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510-6250

MICHAEL L. ALEXANDER, STAFF DIRECTOR
NICHOLAS A. ROSSI, MINORITY STAFF DIRECTOR

December 4, 2012

The Honorable Jeffrey Zients
Acting Director
Office of Management and Budget
725 17th Street, NW
Washington, DC 20503

Dear Mr. Zients:

On October 5, 2011, the Subcommittee held a hearing to explore whether food service contractors could be overcharging the government by withholding rebates or discounts that they may be contractually required to pass through to the government. The Subcommittee's interest in this issue was prompted by litigation relating to overcharges on certain federal and state contracts, including civil and criminal fraud lawsuits brought by the Department of Justice against the Kuwait-based contractor, Public Warehousing Company (PWC), related to \$8.5 billion in Defense Department contracts to supply food to dining facilities and forward operating bases throughout Iraq, Jordan and Kuwait.¹

In response to concerns raised at the hearing, the Subcommittee wrote to eight food service contractors² and fourteen federal agencies³ to request information and documents regarding their rebate and discount policies and the extent to which rebates and discounts were

¹ Defense Logistics Agency, *Operational Evaluation Team (OET) Report* (Apr. 12, 2010). Similarly, in 2010, the State of New York announced that it had reached a \$20 million settlement agreement with the contractor Sodexo over its failure to pass along rebates it had received through its contracts with the New York public schools participating in the National School Lunch Program.

² The Subcommittee requested information from Aramark, Compass Group, Olgoonik, Professional Contract Services, Inc., Sodexo, Sysco, Tamimi and U.S. Foods. U.S. Foods is the re-branded name of U.S. Foodservice. These companies were chosen because they represented the top food service contractors by contract dollar in FY 2010.

³ The Subcommittee requested information from the Department of Homeland Security, Department of Defense, Department of Justice, Department of Labor, Department of State, Treasury Department, General Services Administration, Department of Health and Human Services, Department of Interior, U.S. Agency for International Development, U.S. Department of Agriculture, Department of Veterans Affairs and the Court Services and Offender Supervision Agency. These agencies were chosen because they spent the most food service contracting dollars in FY 2010.

being refunded to the federal government on food service contracts from 2007 to 2011. The Subcommittee also analyzed contract data obtained from the Federal Procurement Data System (FPDS).

The information and documents provided to the Subcommittee indicate systemic deficiencies in the transparency and oversight of contractors' rebate and discount policies. The Subcommittee's analysis reveals that federal agencies have limited transparency into the rebates and discounts received by food service contractors and, as a result, the federal government may be paying more than it should.⁴ The information reviewed by the Subcommittee shows:

- Between 2007 and 2011, contractors reported receiving substantially more rebates and discounts than were refunded to the federal government. Over the last five years, contractors refunded only 5% of the rebates and discounts they reported receiving to the government.
- Federal agencies have limited visibility into the rebate agreements between contractors and their suppliers, which make it very difficult to assess whether contractors are refunding rebates and allowances when required by the contract.
- There is significant variation among food service contractors regarding which discounts and allowances should be defined as rebates. The lack of a consistent definition or reporting of rebates by contractors leads to a wide variation in rebate amounts per contract. The information provided to the Subcommittee shows that contractors report receiving anywhere from \$0.00 to \$0.38 per contract dollar.
- Few agencies have attempted to develop policies on rebates and allowances. The Defense Logistics Agency is a notable exception, but its recent efforts to bring more transparency into its contracts have been met with resistance.
- The best practices of strategic sourcing – moving towards a centralized, aggregated approach to acquisition to best leverage the buying power of the federal government – may be appropriate to apply to the federal government's acquisition of food service.

I request that your office review the Subcommittee's findings and issue guidance to federal agencies to address these deficiencies. I also request that your office consider how the federal government can better leverage its buying power through the strategic sourcing of food service.

⁴ The Subcommittee's analysis relied on publically available data, including federal agency-provided data, in addition to data provided by contractors. As discussed below, there are significant discrepancies among the data and it is requested that any examination of this issue include requests for information to both agencies and contractors.

Background

In 2011, the federal government spent \$6.8 billion on contracts to acquire food service for federal facilities including military bases, cafeterias in federal office buildings and federal courthouses, and concessions at national monuments and in national parks. The federal government also spent more than \$11.1 billion for the National School Lunch Program, under which states receive grants to pay for the costs of food delivered to children at school.⁵

The federal government engages in at least two types of food-related contracting. There are contracts with companies that manage food service facilities, including the preparation and service of meals for military personnel, federal employees, and visitors. The government also contracts with food distributors and vendors, who provide food products and logistical support to deliver food in the United States and around the world.

Generally, a food service company buys food and supplies for its clients from multiple large suppliers and vendors, including well-known companies like Coca-Cola and General Mills. The food service companies receive large discounts from vendors on food purchases through rebates obtained from vendors at all levels in the supply chain.⁶ Sometimes the difference between what food service clients, like the government, pay for food and the cost to the contractor can be significant.

Rebates and discounts obtained by food service contractors have been generally required to be credited to the government under two types of contracts: fixed price contracts with an economic price adjustment, in which initial pricing is based on a “market basket” of prices for certain food items but amounts are adjusted throughout the execution of the contract to reflect actual costs,⁷ and cost-reimbursement contracts, in which the government pays the contractor for its costs and should be entitled to credits on those costs. Economic price adjustment contracts are primarily used by the Defense Department’s Defense Logistics Agency (DLA).⁸

⁵ U.S. Department of Agriculture, Food and Nutrition Service, *Program Information Report* (Mar. 2012) (available at www.fns.usda.gov/fns/data.htm) (accessed June 27, 2012). The National School Lunch Program (NSLP) is administered by state departments of education and local school food authorities, but is reimbursed by the federal government. However, the NSLP does not involve a direct contractual relationship between the federal government and food service contractors.

⁶ As used in this report, “rebate” means money paid to contractors by vendors, manufacturers or suppliers. “Refund” refers to the amount that the government receives when rebates are passed back to the government.

⁷ See Federal Acquisition Regulation § 16.203.

⁸ Defense Logistics Agency, *Briefing for Subcommittee Staff* (Sept. 15, 2011).

Overview of Food Service Contracts

In 2011, the Department of Defense spent \$6.4 billion on contracts for food service. In total, the Department of Defense accounts for 95% of the federal government's direct contract spending for food service.⁹ According to the DLA, which buys food for military bases, ships, mobile field kitchens, among other operations, the federal government spends approximately \$2.3 billion annually for food service associated foreign military operations and \$488 million on domestic food service contracts.¹⁰

The Department of Justice had the most food service contract spending after the Department of Defense, spending \$141.6 million in 2011. Other civilian agencies with significant food service contract spending in 2011 include the Department of Veterans Affairs (\$108.5 million), Department of Homeland Security (\$35 million), Department of Agriculture (\$27.3 million), Department of Interior (\$9.7 million), State Department (\$7.3 million), Treasury Department (\$6.7 million), USAID (\$2.7million), and Department of Health and Human Services (\$1.2 million).

Food service contracting is dominated by a handful of companies. In 2011, the contractors with the most food service spending were Sodexo, Tamimi Group, Professional Contract Services, U.S. Foods, Sysco, Aramark and Compass Group. These contractors received \$291 million in food service contracts in 2011.¹¹

Rebates, Discounts and Refunds

Between 2007 and 2011, contractors reported receiving substantially more rebates and discounts than were refunded to the federal government.¹² Over the last five years, where contractors reported receiving rebates, only 5% of those dollars were refunded to the government.

The Subcommittee was unable to determine the causes for the differences between the rebates and refunds reported. As noted above, not all types of contracts require the refund of rebates. However, several services within the Defense Department had contracts of the same

⁹ As based on contracting dollars reported in the Federal Procurement Data System.

¹⁰ Defense Logistics Agency, *Briefing for Subcommittee Staff* (Sept. 15, 2011).

¹¹ There are significant discrepancies, up to hundreds of millions of dollars, between contracting dollar amounts reported by FPDS and the amounts reported by contractors. It is unknown whether this is a data entry error or an accounting error, but it requires additional scrutiny. According to FPDS, 2011 contracting dollars among the reviewed contractors were: Sysco (\$13 million), U.S. Foods (\$135 million), Sodexo (\$8 million), Compass Group (\$1.9 million), PCS (\$21 million), and Tamimi (\$7 million). FPDS data showed that Olgoonik had no new food service contracts after 2009.

¹² Only three of the contractors actually reported receiving any rebates and subsequently providing refunds to the government.

type but only some services received refunds on those contracts. Further investigation and review of the contract files will be required to explain these discrepancies.

The Subcommittee's analysis was complicated by the significant divergence in the information provided by federal agencies and contractors regarding refunds. For example, while the contractors reported millions of dollars in refunds to the government between 2007 and 2011, many agencies did not report receiving any refunds. This included instances where contractors reported refunding agencies but the agencies, such as GSA, did not report that they received any refunds. The reverse was also true. DLA reported receiving refunds from several contractors, but the same contractors did not report providing any refunds to DLA. Even under contracts where both the agency and contractor were in agreement that quantity discounts were to be refunded, the agency, the Treasury Department, did not report any refunds.

Lack of Transparency

One of the primary obstacles to effective oversight of food service contracts where rebates and discounts are required to be refunded is the lack of transparency. Federal agencies have limited visibility into the rebate agreements between contractors and their multiple levels of suppliers, which make it very difficult to assess whether contractors are refunding rebates and allowances when required.¹³

Contractors have argued that their accounting systems do not allow them to account for rebates on a contract-by-contract basis.¹⁴ In the case where volume discounts should apply, for example, a federal agency should receive its share of the contractor's overall volume discount which is attributable to the contract. However, contractors have claimed that their accounting practices prevent them from accounting for the rebates owed to individual clients. For example, if a contractor purchases several pallets of cereal for multiple clients it cannot account for individual cases of cereal that are then provided to an individual client.

Inconsistent Definition of Rebates

The information received by the Subcommittee suggests that there is significant variation among food service contractors regarding what types of discounts and allowances should be defined as rebates. If the definitions and reporting of rebates were consistent, contractors should have similar amounts of rebates per contract dollar. Instead, the information provided to the Subcommittee shows that contractors report receiving anywhere from nothing to \$0.38 per contract dollar.

¹³ See, e.g., *U.S. v. The Public Warehousing Company*, No. 1:05 CV 2968 (N.D. Ga. 2005), in which Public Warehousing Company allegedly used many different schemes to overbill the government. The concealment of these alleged schemes from the government relied on the many layers that invoices passed through before they were submitted for payment.

¹⁴ Subcommittee on Contracting Oversight, *Hearing on Food Service Contracts: Food Service Management Contracts: Are Contractors Overcharging the Government?*, 112th Cong. (Oct. 5, 2011) (S. Hrg. 112-507).

Rebates to Contract Dollar 2007-2011

Contractor	Rebate /Contract Dollar
Aramark	\$0.02
Compass	\$0.38
Sodexo	\$0.01
PSC	\$0.00
Sysco	\$0.00
US Foods	\$0.00
Olgoonik	\$0.00

In addition, there are a number of payments from suppliers and vendors to contractors which the contractors may not consider to be “rebates.” Contractors refer to these payments as “allowances.” Allowances go by many different names, such as marketing incentives or vendor consideration. These rebates and discounts are typically not shown on invoices. Some allowances may be based on services that contractors provide to vendors, and could therefore arguably be income. Agreements between contractors and their suppliers include the following types of discounts and allowances:

- **Volume Allowances.** Contractors can use their buying power to get rebates based on their total volume of purchases.
- **Promotional/Marketing Allowances.** Contractors can collect fees from suppliers to promote and advertise their products. This kind of fee, which is based on a percentage of the total volume of products sold, is earned through a very detailed agreement which sets out the contractor’s responsibilities for product display, special promotional events, sponsorships, brand exposure and visibility. For example, a contractor could earn a signing bonus and marketing allowances to cooperate with a supplier on its national and local advertising efforts.
- **Preferred Vendor Allowances.** Contractors can collect fees from suppliers that then entitle the vendor to a more favorable position in future bidding processes with the contractor.
- **Performance Fees/Growth Allowance.** Contractors can also collect fees which are tied to specific levels of sales. A typical contract could specify that if the total product purchases made by the contractor exceed the “baseline” amount of purchases established by the

contract then the supplier pays the contractor an allowance based on the growth rate and growth percentage and multiplied by the total volume purchased.

- **Bill-Backs.** Bill-backs aim to recover costs where the supplier, instead of the contractor, absorbs a pricing differential on the invoice. For example, if a box of cereal from a supplier costs three dollars in the market and the contractor only charged the client two dollars on the invoice, the supplier pays the contractor the dollar difference to make up the loss.

It appears that whether a fee paid by a supplier or vendor to a contractor is called a “rebate” is up to the individual contractor unless otherwise specified in its contract with the government. For example, one contractor told the Subcommittee that rebates are determined on a contract-by-contract basis. Another contractor stated that it receives “earned income” for value-added services it provides to vendors and does not consider them to be rebates. A third contractor defines rebates as “amounts received by or credited to [contractor] from vendors that offset or reduce the cost of goods or services purchased from those vendors” and treats them differently depending on the type of contract. A fourth contractor noted that its most recent contract with DLA permitted it to retain rebates described as earned income, promotional allowances, off-invoice discounts, value-added services, growth programs, manufacturer and supplier incentives.

Without additional investigation of the agreements and services provided, the Subcommittee is unable to conclude whether the allowances have been earned or are simply a discount that should be credited to the government.

Federal Policies on Rebates

There are currently no regulations or guidance that directly inform whether agencies can or should seek additional oversight into rebates. Generally, food service contracts fall under the FAR’s provisions relating to commercial contracts. These provisions, found in Part 12, provide a streamlined, almost boilerplate, approach to contracting for commercial items.¹⁵

DLA has tried to use the tools available under the FAR to include contract provisions that would require more transparency into contractors’ receipt of rebates. This approach has been met with mixed results. While DLA’s approach has survived legal scrutiny, DLA has not found a viable way to implement these new transparency provisions.¹⁶ Rather than attempt to find an alternative approach that would not be challenged by contractors, DLA has ceased its efforts.¹⁷

¹⁵ Federal Acquisition Regulation § 12.213.

¹⁶ See *U.S. Foodservice, Inc., v. U.S.*, 100 Fed. Cl. 659 (Fed. Cl. 2011). As to the underlying policy reasons for seeking a commercial contracts waiver, the court stated: “[T]his court cannot conclude that revising the procedures to decrease the incidence of fraud is unreasonable. It would be inappropriate – particularly, in the current fiscal situation – for this court to attempt to hinder the Government from trying new methods to reduce fraud and save the taxpayer money...DLA Troop Support has been the victim of fraud in food-service

Outside of DLA, only the Department of Agriculture has developed regulations or policies on rebates. Since 2007, contracts under the National School Lunch Program have been required include rebate provisions and contractors have been required to pass all discounts, rebates, and other credits back to the school district.¹⁸

No other federal agency reported that it had any specific contracting policies on rebates and allowances. The Treasury Department stated that it used firm, fixed-price contracts for its food service contracts and that it did not have specific policies on rebates, discounts or incentives in food service management contracts.¹⁹ The State Department and Department of Labor reported that the General Services Administration manages food service and concession contracts for those agencies.²⁰

Strategic Sourcing

The best practices of strategic sourcing – moving towards a centralized, aggregated approach to acquisition to best leverage the buying power of the federal government – may be appropriate to apply to the federal government’s acquisition of food service.

In 2012, the Government Accountability Office (GAO) released a report finding that the federal government has failed to capitalize on its immense buying power.²¹ GAO found that agencies “leveraged only a fraction of their buying power through strategic sourcing and achieved limited savings.” GAO recommended that the Office of Management and Budget and federal agencies take actions to apply strategic sourcing to their areas of highest procurement expenditures.

In response to the report, DLA has determined that food purchase is an area that could be targeted through strategic sourcing. With OMB’s support, other federal agencies may also be able to save money and improve efficiencies in the purchase of food by leveraging DLA’s efforts.

distribution contracts, and its attempt to cut down on potential fraud by increasing the transparency of the acquisition process is a reasonable objective for a government agency to pursue.” 100 Fed. Cl. at 680.

¹⁷ Email from Defense Logistics Agency to Subcommittee Staff (June 26, 2012).

¹⁸ 2 C.F.R. 225 App. A § (C)(1)(i) and (C)(4)(a).

¹⁹ Letter from Assistant Secretary for Management Dan Tangherlini, Treasury Department, to Chairman Claire McCaskill (Jan. 11, 2012).

²⁰ Letter from Assistant Secretary for Congressional and Intergovernmental Affairs, Brian V. Kennedy, Department of Labor to Chairman Claire McCaskill (Nov. 3, 2011); Letter from Assistant Secretary for Legislative Affairs, David S. Adams, State Department to Chairman Claire McCaskill (Nov. 21, 2011).

²¹ Government Accountability Office, *Strategic Sourcing: Improved and Expanded Use Could Save Billions in Annual Procurement Costs* (Sept. 2012) (GAO-12-919).

Conclusion

The federal government spends billions of dollars every year to feed service members, federal employees and school children. The information reviewed by the Subcommittee indicates that federal agencies are not adequately addressing the treatment of rebates and discounts under food service contracts. It also indicates that there is an opportunity to improve the management and oversight of these contracts.

In our current budget climate, we cannot miss any opportunities to better safeguard taxpayer dollars. For this reason, I request that the Office of Management and Budget examine food service contracts and take appropriate action, including issuing guidance, to address the concerns raised by the Subcommittee's analysis. I also request that, if necessary, the Office of Management and Budget advise me whether changes to law or regulation may be required to achieve the most efficient, effective, and transparent use of taxpayer dollars spent through food service contracts.

Please have your staff contact Sarah Garcia or Margaret Daum at (202) 224-4462 with any questions. Please send any official correspondence relating to this request to Kelsey_Stroud@hsgac.senate.gov.

Sincerely,



Claire McCaskill
Chairman
Subcommittee on Contracting Oversight

cc: Rob Portman
Ranking Member
Subcommittee on Contracting Oversight