

**PRIVATIZATION IN THE NEW MILLENNIUM:  
OLD APPROACHES AND NEW IDEAS**

D R A F T

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## INTRODUCTION

### *Introduction*

This article examines the outsourcing and privatization initiatives that are currently affecting the Department of Defense (DOD) and civilian federal agencies as they deal with budgetary and management pressures to provide services on a more cost effective and efficient manner. The article first examines the competitive sourcing process embodied in Office of Management and Budget (OMB) Circular A-76 and points out some of the difficulties contained in the Supplemental Handbook that implements the Circular. Specifically, the article examines the accounting history and theories that apply separately to the public sector and the private sector, and it notes that there is now a need for a careful examination of those theories as the General Accounting Office (GAO) undertakes the Congressionally mandated review of the process. The article then turns its focus on two alternative transactions to the competitive sourcing A-76 process: ESOPS and the Transitional Benefit Corporation (TBC) model. Both of these alternatives are forms of privatization that are exempt from the A-76 process and, therefore, do not subject the affected employees to an A-76 competition. As a result, unlike the situation under an A-76 competition where the government bidding unit -- the Most Efficient Organization (MEO) -- has to shed approximately one-third of its staffing in order to be competitive, under either the ESOP or TBC model the employees move into the private sector intact with all personnel retaining jobs for at least a transitional period and, hopefully, much longer as they generate economic development and growth. The article explores in detail the mechanics of the ESOP and TBC transactional model.

### **Today's Anomaly**

Imagine that you are a civilian worker at a Department of Defense ("DOD") installation. You have just learned that your position has been announced to Congress as the subject of competition under the rules for competitive sourcing and pursuant to Office of Management and Budget ("OMB") Circular A-76.<sup>1</sup>

The news is not entirely surprising inasmuch as you already know that your position has been classified as being "commercial in nature" under the annual inventory assembled by DOD as required by the Federal Activities Inventory Reform ("FAIR") Act.<sup>2</sup> Nevertheless, the news is unsettling because you know that there is a fifty-fifty chance that your group -- dubbed the Most Efficient Organization ("MEO")<sup>3</sup> -- may not win in its competition against the private sector. Moreover, you know that in assembling its proposal, the MEO will likely only include approximately two-thirds of the existing employees in the activity under competition in order

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<sup>1</sup> See Circular No. A-76 -- Revised Supplemental Handbook: Performance of Commercial Activities, Office of Management and Budget (March 1996).

<sup>2</sup> See Federal Activities Inventory Reform Act, Pub. L. No. 105-270, 112 Stat. 2382 (1998). Under FAIR, executive agencies, including DOD, are required to publish a yearly list of its activities that are not inherently governmental and are performed by a government source. As defined in § 5 of the Act, inherently governmental positions generally require the exercise of discretion in applying government authority or the use of value judgments in making decisions for the government.

<sup>3</sup> See Circular No. A-76 -- Revised Supplemental Handbook, at 3.

to be competitive.<sup>4</sup> You also know that despite years of loyal service and the expectation of steady, gainful employment, there is a real risk that you may lose your job due to forces beyond your control; forces such as cost savings and management reform initiatives in the form of A-76 and Strategic Sourcing<sup>5</sup>. And you know that under the rules governing cost comparisons under A-76, the winner is frequently determined based on cost factors entirely beyond your control, such as a delay in the issuance of a wage determination or any one of the rather arcane set of cost rules found within the A-76 Revised Supplemental Handbook: Standard Cost Factors, Common Costs, Retained and Saved Pay, Cost of Conducting a Cost Comparison, In-House Costs, Minimum Cost Differentials, and their various sub-elements.<sup>6</sup> You also know that it will likely take up to four years before the outcome of the A-76 competition is decided.<sup>7</sup>

At the same time that DOD is looking to downsize its civilian workforce and take a critical look at its strategic needs for the next half century, you observe that the nonfederal government marketplace is experiencing record or near-record lows in unemployment and productivity. Companies in the private sector are having continued difficulties in recruiting and retaining skilled, dependable workers in almost all employment categories. They are using mergers and acquisitions as methods to grow top line and bottom line revenues. They are looking for ways to pick up blocks of employees who, as a group, are used to working together as a business unit. There are clearly larger forces at play as the Bush Administration attempts to hold the line on substantial increases in government spending while still transforming the military to meet the challenges of ballistic missile defense, terrorism, cyber-terrorism, and biological and chemical weapons.<sup>8</sup>

So, you have to ask some fundamental questions: Knowing that budgetary pressures on DOD components will not be dissipating and that the A-76 process is here to stay for the

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<sup>4</sup> See Christopher Snyder, Robert Trost & R. Derek Trunkey, *Bidding Behavior in DOD's Commercial Activities Competitions*, Center for Naval Analysis Research Memorandum 97-68 (January 1998).

<sup>5</sup> The Strategic Sourcing Concept was proposed by DOD and approved by the Under Secretary of Defense for Acquisition and Technology. The Strategic Sourcing Program is intended to maximize effectiveness, efficiencies, and savings throughout the Department of Defense and provide an approach for DOD Components to use in meeting their competitive sourcing goals. It provides a broader approach than the traditional OMB Circular A-76 processes by extending the opportunities to achieve efficiencies to areas that are exempt from the A-76 competitive processes. This Program should not be interpreted as avoidance or replacement of A-76 and its focus upon fair competitions to achieve both cost efficiency and the infusion of best business practices. A-76 competition is, and will continue to be, a dominant factor in the Department's plan to do our business more effectively and efficiently. See J. S. Gansler, *Memorandum from the Under Secretary of Defense (Acquisition and Technology): Strategic and Competitive Sourcing Programs, Interim Guidance*, April 3, 2000.

<sup>6</sup> See Circular No. A-76 -- Revised Supplemental Handbook, at 9; see also *Rice Servs., Ltd.*, B-284997, 2000 CPD ¶ 113 (June 29, 2000), 42 GC ¶ 298 and *Aberdeen Technical Servs.*, B-283727.2, 2000 CPD ¶ 46 (Feb. 22, 2000), 42 GC ¶ 89.

<sup>7</sup> See United States General Accounting Office, *DOD Competitive Sourcing: Questions About Goals, Pace, and Risks of Key Reform Initiative*, GAO/NSIAD-99-46, at 13 (Feb. 1999).

<sup>8</sup> Thomas E. Ricks, *Rumsfeld Outlines Defense Overhaul*, THE WASHINGTON POST, March 23, 2001, A01.

foreseeable future, are you willing to endure up to four years of uncertainty about whether you will keep your job? If you decide to leave the federal service in order to find a more secure employment environment, what will this do to your pension and medical benefits that you expect to receive upon retirement? If you leave federal service, do you have the skills and attitude to be successful in another employment situation in the private sector?

These are some of the human issues that confront the DOD community and all public sector organizations striving to achieve a new balance of mission and resources.<sup>9</sup> They reflect a larger concern: what will the federal government look like five or more years from now? Many of our most skilled and valuable employees will depart public service creating a human capital void. Savings will be realized, but overall efficiency and effectiveness may be degraded.

### **A Bit of History**

How did we get to this point? The federal budget is now moving towards balance, and everywhere there are demands for providing better public services for the same or less money. The federal civilian workforce has now been reduced to the size that it was during the Kennedy Administration,<sup>10</sup> and the demands on military readiness have, in many respects, increased since the end of the Cold War. The U.S. economy has enjoyed a stable period of record-low inflation and unemployment, and the long-term prospects look quite promising even though there are legitimate concerns about the current financial climate. If you are a taxpayer and have a stake in the American economy, these are good times.

Yet, if you happen to work in the Department of Defense (DOD) or for a civilian agency that is downsizing to meet lower budget targets, these are not particularly happy times. Under the Clinton Administration, DOD announced that it intends to study at least 203,000 of those positions using managed competitions under the auspices of Office of Management and Budget ("OMB") Circular A-76 with estimated savings of roughly \$9.2 billion in operating costs between FY 1997 and FY2005 and \$2.8 billion in annual recurring savings after FY 2005.<sup>11</sup> The Bush Administration's OMB has announced that it intends to intensify the use of A-76 to achieve even larger savings and management reforms.<sup>12</sup> There are calls from the private sector and the Pentagon to increase the pace of outsourcing and privatization,<sup>13</sup> and there is a clear call for another round or two of base closures as DOD managers begin to examine the proper strategies for the new century.<sup>14</sup>

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<sup>9</sup> See United States General Accounting Office, *Federal Workforce: Payroll and Human Capital Changes During Downsizing*, GGD-99-57 (August 13, 1999).

<sup>10</sup> See *id.*

<sup>11</sup> See *Long-Run Costs and Performance Effects of Competitive Sourcing* at 1, Center for Naval Analysis (February 2001).

<sup>12</sup> See Mitchell E. Daniels, Jr., Director, Office of Management and Budget, Memorandum for the Heads and Acting Heads of Departments and Agencies, *Performance Goals and Management Initiatives for the FY 2002 Budget*, Attachment (February 15, 2001). ([www.whitehouse.gov/omb/memberandum01-11.html](http://www.whitehouse.gov/omb/memberandum01-11.html)).

<sup>13</sup> See Paul Taibl, *Logistics Transformation: DOD's Opportunity to Partner with the Private Sector*, Business Executives for National Security Issue Brief (October 1999).

<sup>14</sup> See *Sens. McCain, Levin Offer Bill to Authorize Two More Rounds of Base Closures*, Fed. Cont. Rep. (BNA), Vol. 75 No. 10 at 255 (March 6, 2001). Senators McCain and Levin introduced S. 397, which would authorize two additional rounds of base realignments

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## The Legislative Backdrop: The CFO Act and GPRA

The reforms aimed at making the government more efficient and better managed have been going on for some time now. In recent years, Congress enacted the Chief Financial Officers (CFO) Act of 1990<sup>15</sup> and the Government Performance and Results Act (GPRA)<sup>16</sup> for performance-based management and accountability. Under GPRA, each Executive Branch agency must issue plans that lay out the long-term goals and strategies the agency will implement in order to achieve those goals.<sup>17</sup> Thereafter, each agency develops annual performance plans that identify the agency's annual goals and strategies as well as the resources that will be used to achieve those yearly goals.<sup>18</sup> The first of these plans, to cover fiscal year 1999, were submitted to Congress in 1998, and the Bush Administration is using GPRA as one of the main vehicles to achieve management reforms.<sup>19</sup>

In establishing its annual performance plan, the OMB and the Congress expect an agency to consider using a number of management tools, including OMB Circular A-76, in determining what the agency is trying to achieve and how best to achieve it. The General Accounting Office (GAO) issued a guide in February 1998 for Congress to use in assessing annual performance plans.<sup>20</sup> In that guide, GAO noted that Congress could examine the plans from the standpoint of whether they show evidence that various approaches, were considered in determining how best to deliver products and services. More directly, the annual performance plans can provide a ready-made, annual vehicle for Congress to use to inquire about agencies' efforts to ensure that the most cost-effective strategies are in place to achieve agencies' goals. As part of this inquiry, the Congress can ask agencies about the tools the agencies are using to increase effectiveness, including the status of A-76 programs, and the specific choices the agencies have made whether to keep a commercial activity in-house or contract it out.<sup>21</sup>

### PART ONE: OMB CIRCULAR A-76

#### I. History of OMB Circular A-76

When the need to downsize the military occurred some time ago during times of economic optimism and expansion, in 1955 the Eisenhower Administration introduced Bureau of the Budget Bulletin No. 55.4, which called for reliance on the private sector to perform commercial activities for needed goods and services. In 1966, the Office of Management

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and closures ("BRACs") in fiscal years 2003 and 2005. According to the senators, the additional base closures could result in savings of \$20 billion by 2015 and \$3 billion a year thereafter.

<sup>15</sup> See Chief Financial Officers Act of 1990, Pub. L. No. 101-576, 104 Stat. 2838 (1990).

<sup>16</sup> See Government Performance and Results Act, Pub. L. No. 103-62, 107 Stat. 285 (1993).

<sup>17</sup> See *id.* The first of the strategic plans was provided to Congress in 1997.

<sup>18</sup> See *id.*

<sup>19</sup> See *Bush Favors Fewer Federal Managers, More Outsourcing, Performance Pay*, Fed. Cont. Rep. (BNA), Vol. 73, No. 24, at 660 (June 13, 2000).

<sup>20</sup> See United States General Accounting Office, *Agencies' Annual Performance Plans Under the Results Act: an Assessment Guide to Facilitate Congressional Decisionmaking*, GGD/AIMD-10.1.18 (February 1998).

<sup>21</sup> See *id.*

and Budget (OMB) -- the successor of the Bureau of the Budget -- issued OMB Circular A-76 (the Circular). OMB updated the Circular several times including most recently in 1983. OMB also issued a Supplemental Handbook in 1979 that included detailed procedures for competitively determining whether commercial activities should be performed (1) in-house, (2) by another agency through an interservice support agreement (ISSA) (also known as "franchising" as that term is used in the 1994 Government Management Reform Act (GMRA)), or (3) by the private sector.<sup>22</sup> OMB revised the Supplemental Handbook in 1983, and then issued its latest version in March 1996.<sup>23</sup> The latest version is intended to resolve many of the concerns about conducting competitions on a relatively level playing field and to make the process less burdensome on all players. The key is to introduce competition into the process and create the incentives necessary to achieve savings, improve efficiency, and maximize effectiveness.

## **II. The Basics of OMB Circular A-76**

The stated philosophy underlying the Circular expresses a clear preference to use the private sector in supplying products and services to meet the Government's needs, when cost effective:

In the process of governing, the Government should not compete with its citizens. The competitive enterprise system, characterized by individual freedom and initiative, is the primary economic strength. In recognition of this principle, it has been and continues to be the general policy of the Government to rely on commercial sources to supply the products and services the Government needs.<sup>24</sup>

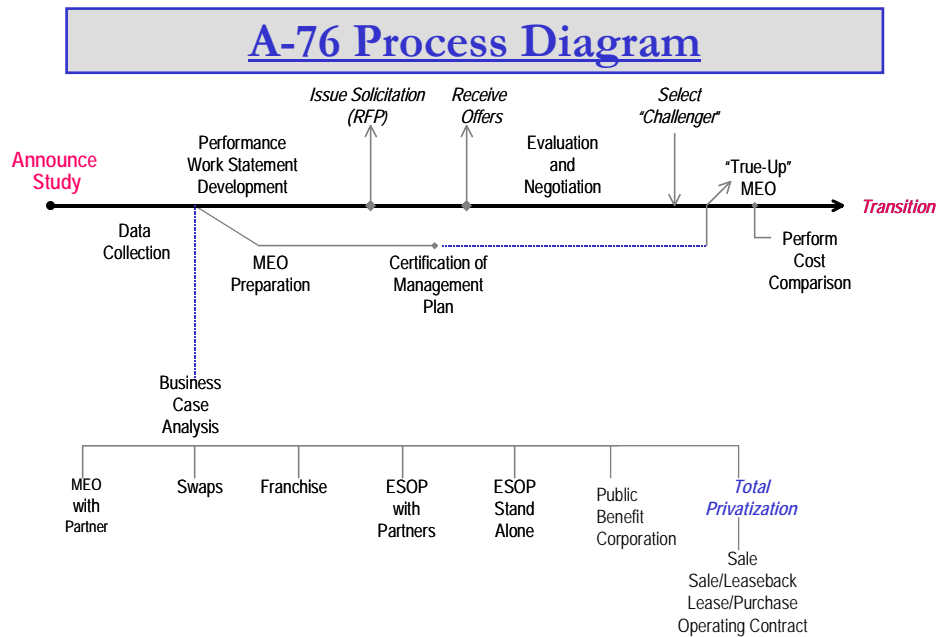
To effectively understand the Circular, It is important to keep some key definitions in mind. Under the Circular and DOD pronouncements, A-76 is synonymous with the concept of managed competition. Managed competition means that in-house employees compete against other entities (the private sector and ISSAs) for the work. Outsourcing has been used synonymously with the concept of managed competition, but many are confused because some use the term to mean contracting out directly to the private sector without giving in-house employees the opportunity to compete for the work. Nevertheless, DOD uses the term outsourcing to mean managed competition under A-76. In contrast, when an agency decides not to continue a function or activity, it may then privatize the function or activity, as in the case of an asset sale such as the recent creation of the U.S. Enrichment Corporation or the sale of the Elk Hills Oil Petroleum Reserves. As will be discussed more fully below, another variant on privatization is spinning off the in-house employees into an Employee Stock Ownership Plan (ESOP) company on either a stand-alone or business-combination basis. Still another alternative is the Transitional Benefit Corporation Model, which is also discussed more fully below.

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<sup>22</sup> See Circular No. A-76 -- Revised Supplemental Handbook, at iii.

<sup>23</sup> See *id.*

<sup>24</sup> OMB Circular A-76 (1966).



While much is being said about privatization, less is actually being done at the federal level as compared to outsourcing under the Circular. This stands in marked comparison to privatization activity at the state and local levels of government in the United States. One area, however, that may see marked change is DOD housing and utilities. For example, the housing program was recently re-authorized for another three years. With respect to utilities, the Deputy Secretary of Defense, in his Defense Reform Initiatives (DRI), has set 2003 as the date by which DOD would be exiting ownership of all utilities -- water, wastewater, electricity, gas, and steam -- where it makes sense economically to do so.<sup>25</sup> Another area of privatization activity is information technology, thanks to passage of the Clinger-Cohen Act.<sup>26</sup>

From the start, some agencies -- such as the National Aeronautics and Space Administration, the Environmental Protection Agency, the Health Care Financing Administration, and the Department of the Energy -- have relied predominately upon the private sector. Others, such as the Department of Defense, the Veterans Administration, the Agriculture Department and the General Services Administration, are now moving aggressively to explore use of the private sector. This certainly appears to be the trend for the near term, and it is changing the way that industry and the government will do business. Government program managers will need to learn how to be effective contract managers and move away from supervisory roles and responsibilities that focused mostly on budget concerns and less on obtaining desired results through intelligent contract administration.

<sup>25</sup> See GAO Says Defense Reform Initiative Progress Varies, Attention to Funding Needs Required, Fed. Cont. Rep. (BNA), Vol. 71, No. 20 (May 17, 1999).

<sup>26</sup> See Pub. L. 104-106 (1996). The Clinger-Cohen Act was formerly known as the Information Technology Reform Act ("ITMRA") and was passed in 1996 as part of the broader Federal Acquisition Reform Act ("FARA").

The private sector will also have to adjust as public/private managed competition opportunities, as well as performance based contracting, become the norm.

DOD has consistently reported savings from reviewing an agency's operations. In making changes to meet the competitive requirements of A-76, the DOD has yielded an average of 20 percent savings, regardless of whether the work remains in-house or not. This is in line with the findings of the Center for Naval Analysis (CNA) in its 1993 Analysis of the Navy's Commercial Activities Program.<sup>27</sup> CNA found that since 1979 the Navy's A-76 program reviewed about 29,000 billets, of which roughly half were contracted out.<sup>28</sup> The average cost study achieved savings of about 30 percent, which was close to 40 percent of the original cost of performing a function if that function was contracted out and 20 percent if it remained in-house.<sup>29</sup>

### **III. The Current Procedure -- The Revised Supplemental Handbook**

The current A-76 process is presented in OMB's March 1996 Revised Supplemental Handbook.<sup>30</sup> It is a complicated document that does not lend itself to quick reading, but it does attempt to strike a fair balance between the competing interests of the in-house workforce, ISSAs, and commercial contractors. It is not possible to present all of the nuances of the A-76 program here -- we teach a three-day basic course and a two-day advanced course on the subject at the George Washington University Law School's Government Contract Program -- but a quick overview is appropriate.

GAO describes the current program as follows:

To compare costs of in-house versus contractor performance, OMB's supplemental handbook requires the government to conduct a management efficiency study. In this study, the government reviews its organizational structure, staffing, and operating procedures to determine the most efficient and effective way of performing an activity with in-house staff. Based on this "most efficient organization" (MEO), the government prepares an in-house cost estimate and compares it with the best offer from the private sector.<sup>31</sup>

Each agency and service has its own approach to performing an A-76 cost comparison study, but the steps are substantially the same. The Navy's approach is illustrative of the process and is broken down into 15 steps as follows:

1. Plan for Commercial Activities Study
2. Develop PWS and QASP (coordinated with developing the Management Plan - see Step 7)
3. Review and Revise PWS and QASP

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<sup>27</sup> See Alan Marcus, *Analysis of the Navy's Commercial Activities Program*, Center for Naval Analysis Research Memo. 92-226 (July 1993).

<sup>28</sup> See *id.*

<sup>29</sup> See *id.*

<sup>30</sup> See generally Circular No. A-76 -- Revised Supplemental Handbook.

<sup>31</sup> United States General Accounting Office, *Defense Outsourcing: Better Data Needed to Support Overhead Rates for A-76 Studies*, GAO/NSIAD-98-62, at 2 (February 1998).

4. Obtain High Level Approval of PWS and QASP
5. Conduct Presolicitation Actions
6. Prepare and Issue Solicitation
7. Develop the Management Plan
8. Respond to Solicitation (Closing Date)
9. Perform Independent Review ( Prior to Closing Date)
10. Evaluate Proposals (If an RFP was issued) or Open Bids (for IFBs)
11. Obtain Prenegotiation Clearance (for negotiated procurements where discussions are appropriate)
12. Conduct Discussions with Offerors
13. Obtain Final Clearance Approval for Selecting Best Value Contractor Proposal (if best value was the source selection methodology, which is usually the case for contractor source selection)
14. Compare Government and Contractor Proposals
15. Announce Tentative Decision

Typically, Step 1 occurs first and takes approximately one month. Step 5 begins next and lasts through to the issuance of the solicitation for contractor bids or offers. Steps 2 and 7 begin at the end of Step 1. Step 2 ends with the issuance of the solicitation as is the case for Steps 3 and 4 which commence once the draft PWS is written and occur consecutively. Steps 6 and 8 occur while the solicitation process involving the private commercial contractors goes forward ending with the proposal evaluation process or bid opening. Step 9 also must be completed before bids or offers are received. Steps 10 through 15 occur next in consecutive order. The Navy had once expressed hopes to complete the entire process in 12 months but experience has shown that this is a very aggressive timeframe given OMB's mandate that cost comparisons for single activities be completed within 18 months or 36 months for multiple activities. Recent legislation now calls for the DOD to complete these studies within 24 and 48 months, respectively.

The Army follows a slightly different methodology, but the sequencing is essentially the same. The Army formalizes a data collection and analysis task prior to writing the PWS, and there is a separate step involved in drafting performance requirements prior to delivering the management plan. The Air Force has a more detailed approach which covers the same territory in a slightly different sequence.

As you can see, the competitive process is distinctive because it occurs on two tracks.<sup>32</sup> For the in-house employees, the effort initially is focused on developing a solid PWS, which is the key to the entire A-76 program.<sup>33</sup> The PWS serves as the scope of work and is the basis for

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<sup>32</sup> See generally Circular No. A-76 -- Revised Supplemental Handbook, at 10-12.

<sup>33</sup> This is a topic that has received a lot of attention by several agencies, including NASA and the Office of Federal Procurement Policy ("OFPP"). OFPP issued OFPP Pamphlet #4 in

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all costs entered on the Cost Comparison Form. Once the PWS drafting process is sufficiently mature but not yet completely done, the people who will staff the management plan effort begin their work in developing the MEO. At some point after the process to develop the MEO and Management Plan commences, the contracting officer will issue an IFB or RFP which contains the PWS, in Section C of the solicitation document. The Management Plan also includes the QASP, an analysis of assets to be used by the MEO but which are not available to ISSAs or contractors, a transition plan from the status quo to the MEO, ISSA, or contractor, and the in-house cost estimate.

The Management Plan and MEO are considered to be procurement sensitive documents and are delivered as sealed documents to the contracting officer prior to the date that initial offers (for RFPs) or bids (for IFBs) are due from the private sector. No private sector offer or bid is opened or otherwise reviewed prior to the sealing of the government's in-house estimate. Once delivered to the contracting officer, the government's cost estimates are certified in writing by the agency's designated Independent Review Officer (IRO), or designee, as being in full compliance with the procedures and requirements of the A-76 Supplement. After certification, the Management Plan remains in sealed envelopes until the competitive process (usually conducted on a best value basis) for selecting the "winning" contractor is completed. At that point, the contracting officer must determine whether the PWS has evolved during the competitive contractor selection process by virtue of amendments to the solicitation documents or otherwise. If such a change has occurred, the in-house people in charge of the Management Plan must make all changes necessary to meet the revised and final PWS performance standards accepted by the Source Selection Authority. Once the changes are made, the final selection between the MEO and the "winning" private contractor (which could be an ISSA) is made on the basis of low price after taking into account the "minimum cost differential" which is the lesser of 10 percent of in-house personnel-related costs or not to exceed \$10 million over the performance period. Factors such as decreased productivity, and other costs of disruption that cannot be easily quantified at the time of the cost comparison are included in this differential. By the way, in the event the A-76 competition involves a commercial contractor as the incumbent, the minimum cost differential works in favor of the incumbent.

The parallel source selection process for private contractors very much tracks the traditional procurement methodology outlined in the FAR.<sup>34</sup> Generally, the procurements are negotiated using Request for Proposals, and the evaluation scheme is based on best value language with an emphasis on past performance. However, in recognition of the fact that the ultimate selection between the MEO and the private "winning" contractor will be based on low price; contractors who are aware that the final selection between the MEO and the private sector winner is based on low cost will typically not offer technically superior approaches that are more costly than lower quality, lower cost approaches which are nonetheless compliant with the terms of the PWS.

#### **IV. A-76 and Costs**

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October 1980 and has been working more recently on a guide to writing Performance Based Service Contracts. On July 13, 1998, OFPP issued a Notice of Availability of Draft Performance Based Service Contracting Documents on Selected Professional and Technical Services. The Acquisition Reform Network has a web site on the topic ([www.arnet.gov](http://www.arnet.gov)) that is quite helpful.

<sup>34</sup> See generally FAR Subchapter B (2001).

## A. The Cost Comparison Problem

GAO has also roundly criticized the budget and accounting practices of all the agencies. In testimony on the Circular's Oversight and Implementation to the Senate Subcommittee on Oversight of Government Management, Restructuring and the District of Columbia, Committee on Governmental Affairs, the GAO's Associate Director of Federal Management and Workforce Issues stated that "[t]he governments lack of complete cost data, particularly indirect costs, has increased the difficulty of carrying out the A-76 competitive process, because the government is not able to accurately determine the cost of the function or activity it plans to compete."<sup>35</sup> Indeed, the GAO has found that "[t]he cost data needed to develop indirect costs factors that represent these costs, such as overhead rates, are not readily available."<sup>36</sup> While the GAO recognizes that efforts are under way to improve government cost data and supporting systems, it also knows that it could be several years before significant improvements are made.<sup>37</sup>

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<sup>35</sup> See J. Christopher Mihm, OMB Circular A-76: Oversight and Implementation Issues, Testimony Before the Senate Subcommittee on Oversight of Government Management, Restructuring, and the District of Columbia, Committee on Governmental Affairs, p. 9 (June 4, 1998). Mr. Mihm is the Associate Director of Federal Management and Workforce Issues at the GAO.

<sup>36</sup> See *id* at 9-10. The Associate Director continued:

In our audit of the consolidated financial statements of the U.S. government for fiscal year 1997, we noted significant financial management deficiencies. We found that financial weaknesses; problems with fundamental recordkeeping; incomplete documentation; and weak financial controls, including computer controls; prevent the government from accurately reporting a large portion of its assets, liabilities, and costs. These deficiencies affect the governments ability to accurately measure the full cost and financial performance of programs and to efficiently manage its operations. For example, in January 1998, we reported that DOD has no reliable means of accumulating actual cost data to account for and manage resources. Moreover, in a February 1998 report, we noted that it will likely be many years before DOD is capable of providing accurate and reliable cost data.

<sup>37</sup> See *id* at 10. In fact, Associate Director Mihm believes that [c]ontinuing efforts to implement the Chief Financial Officers Act (CFO Act) are central to ensuring that agencies resolve their long-standing problems in generating vital information for decision makers. In that regard, the Federal Accounting Standards Advisory Board (FASAB) has developed a new set of accounting concepts and standards that underpin OMB's guidance to the agencies on the form and content of their agency wide financial statements. [The FASAB was created in October 1990 by the Secretary of the Treasury, the Director of OMB, and the Comptroller General to consider and recommend accounting principles for the federal government. If accepted by Treasury, OMB, and GAO, the standards are adopted and issued by OMB and GAO. A counterpart to the FASAB standards are the Cost Accounting Standards (CAS) which are issued by the Cost Accounting Standards Board (CASB) and which are binding upon larger "CAS covered" private sector companies and organizations that do business with the government.]

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In February 1998, the Joint Financial Management Improvement Program (JFMIP) issued a document entitled "Managerial Cost Accounting System Requirements."<sup>38</sup> In its introduction, the JFMIP explains that the document "builds upon, and provides a means to implement, requirements related to cost accounting set forth in the Chief Financial Officers Act (CFO Act), Government Performance and Results Act (GPRA), Statements of Federal Financial Accounting Standards (SFFAS), Office of Management and Budget (OMB) circulars, and other sources. . . . The document establishes the standard."<sup>39</sup> See *id.* The JFMIP explains in great detail the government-wide system requirements that an agency should consider for systems supporting managerial cost accounting functions. The JFMIP also notes that it allows flexibility to address agency-specific requirements, such as those associated with the choice of costing methodology.

Agencies must report at least a certain minimum level of cost accounting and provide a basic amount of cost accounting information necessary to accomplish the many objectives associated with planning, decision making, and reporting. This minimum level includes collecting cost information by responsibility segments, measuring the full costs of outputs, providing information for performance measurement, integrating cost accounting and general financial accounting with both using the Standard General Ledger, providing the appropriate precision of information, and accommodating any of management's special cost information needs that may arise due to unusual or special circumstances.

In general, a cost accounting system is a continuous and systematic cost accounting process which may be designed to accumulate and assign costs to a variety of objects or as desired by the management. Even if the agency is using commercial off-the-shelf software, agency management still needs to make decisions regarding the cost objects to be defined, the costing methodology to be used, the types of costs to be included for each reporting or decision making purpose (e.g., full cost), and other items of a similar nature.

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As part of that effort FASAB developed managerial cost accounting concepts and standards. These managerial cost accounting concepts and standards require that federal agencies provide reliable and timely information on the full cost of federal programs and on their activities and outputs. Specifically identified in the standards is the need for information to help guide decisions involving economic choices, such as whether to do a project in-house or contract it out. Such information would allow agencies to develop appropriate overhead rates for specific operations. These cost accounting standards became effective for fiscal year 1998. Some agencies' Chief Financial Officers have expressed concern about their agencies' ability to comply with the cost accounting standards this year.

<sup>38</sup> See JOINT FINANCIAL MANAGEMENT IMPROVEMENT PROGRAM, FFMSR-8, SYSTEM REQUIREMENTS FOR MANAGERIAL COST ACCOUNTING (February 1998). JFMIP is a joint and cooperative undertaking of the Department of Treasury, the GAO, OMB, and the Office of Personnel Management (OPM), and operates under authority of the Budget and Accounting Procedures Act of 1950.

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Also, cost information is essential in the following five areas: (1) budgeting and cost control, (2) performance measurement (3) determining reimbursements and setting fees and prices, (4) program evaluations, and (5) making economic choice decisions. The concepts section of SSFAS Number 4 states that cost information should be presented using the appropriate basis of accounting (e.g., accrual) and recognition/measurement standards for the intended use of the information. Using different bases of accounting and cost accounting methods can produce different costs for the same item, activity, or entity, which can confuse users of to information. Therefore, a key concept is that reports using different accounting bases or different methods for recognition and measurement should be reconcilable, and they should fully explain those bases and methods.

The managerial cost accounting system must capture (or share with other systems) all data an costs needed to determine the costs of outputs and the total net cost of the entity's operations, with the appropriate disclosures of the components of net cost [w]ith respect to each responsibility segment the costs that are to be assigned to outputs include: (a) direct and indirect costs incurred within the responsibility segment, (b) costs of other responsibility segments that are assigned to the segment, and (c) inter-entity costs recognized by the receiving entity and assigned to the segment

Government-wide system requirements that an agency should consider for systems supporting managerial cost accounting functions, but also allows flexibility to address agency-specific requirements, such as those associated with the choice of costing methodology (e.g. activity-based costing.)

GPRA and the CFO Act are important because they provide the underpinnings for any reasonable cost based analysis of government activities. In a perfect world, government managers would be able to isolate a particular unit or activity within government and, using the above techniques, identify all reasonable costs associated with that unit or activity. However, as it has become clear during the conduct of A-76 competitions in recent years, this type of comprehensive cost accounting information is rarely available in the type useful to cost comparisons between the public and private sectors.

During the 104th Congress, two bills designed to promote outsourcing and privatization were advanced but not enacted.<sup>40</sup> They came back to life in the 105th Congress in the form of the Thomas-Duncan Bill, popularly known as the Freedom from Government Competition Act.<sup>41</sup> As discussed later in this paper, the legislation evolved into the FAIR Act which was signed by the President on October 19, 1998. The legislation gained favor, in part, after reports of the ICEMAN procurement infuriated certain members of the private sector. In that procurement the Federal Aviation Administration (FAA) awarded a data center contract worth up to \$250 million to the Agriculture Departments National Information Technology Center in Kansas City under a reimbursable Inter Service Support Agreement (ISSA).<sup>42</sup> The Center competed against IBM, Computer Sciences Corporation (CSC), and a third private sector firm as well as ISSA proposals from the Defense Information Systems Agency (DISA) and the

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<sup>40</sup> See S. 314, 104<sup>th</sup> Cong. (1996) and HR 1724, 104<sup>th</sup> Cong. (1996).

<sup>41</sup> See Office of Federal Procurement Policy (1998). The Freedom From Government Competition Act originated as S.314, sponsored by Senator Craig Thomas, and a House counterpart sponsored by Representative Thomas Duncan.

<sup>42</sup> For information on ISSA, see *generally* Circular No. A.76 - Revised Supplemental Handbook, at 10-12, 36.

Department of Transportation's Administrative Service Center (TASC). Although not covered by the Circular, the FAA conducted the procurement using some of the Circular's approach including the best value source selection criteria which was to make contract award to the lowest-cost, highest-quality support.

Questions were immediately raised such as how could there be a common basis for comparing offers among the entities if they do not have common accounting practices. The Government follows FASAB and is supposed to be implementing the CFO Act to establish overhead rates whereas IBM and CSC are subject to CAS. FASAB does not require the Center to fully allocate costs to a business unit whereas CAS does require every CAS covered contractor to fully allocate costs. The Center did not have to account for its bid/proposal costs whereas IBM and CSC did have to include those costs in their overhead pools. The Center does not pay taxes or pay for insurance. IBM and CSC do pay taxes and insurance, and they must also account for earning a profit. So, there was a perception that the cost comparison that led to the award to the Center was unfair in that the cost comparison did not compare comparable costs.<sup>43</sup>

In recognition of these and other cost disparities, the Chief Financial Officers Council had already begun addressing the need for a level playing field for industry and government as the entrepreneurial franchise organizations began to compete against private industry for administrative support services.<sup>44</sup> The CFO Council developed 12 operating principles for

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<sup>43</sup> See Michael D. Serlin, *In the Ring*, GOVERNMENT EXECUTIVE, September 1, 1997. In a story that became front page news in The Washington Post and elsewhere, Mr. Serlin reported that "industry officials complained that the bids hadn't been properly adjusted to account for taxes and other factors." He continued that the

FAA delayed implementing the pact to determine whether contracting officials had fully complied with Office of Management and Budget Circular A-76 guidance on calculating whether services can be provided more cost-effectively by private firms. In early June, the USDA Center was confirmed the winner.

Then Congress got into the act. A previously unheralded measure, the Freedom from Government Competition (S. 314) assumed a higher profile. Witnesses and spectators turned out in force when its sponsor, Sen. Craig Thomas, R-Wyo., held June [1997] hearings on the bill before a Senate Governmental Affairs subcommittee. [OMB officials disagree with this account by noting that the FAA did conduct customer surveys and applied the appropriate adjustments called for by the Circular including accounting for taxes and applying the 10% cost differential.]"

<sup>44</sup> See Pub. L. 101-576, § 302. The Chief Financial Officers Act established a Chief Financial Officers Council, consisting of (1) the Deputy Director for Management of the Office of Management and Budget, who shall act as chairperson of the council; (2) the Controller of the Office of Federal Financial Management of the Office of Management and Budget; (3) the Fiscal Assistant Secretary of Treasury; and (4) each of the agency's appointed Chief Financial Officers. The function of the CFO Council is to advise and coordinate the activities of the agencies of its members on such matters as consolidation and modernization of financial systems, improved quality of financial information, financial data and information standards, internal controls, legislation

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business-like federal organizations. They stressed the need for full and open competition, with franchise organizations operating on a self-sustaining basis with "full cost recovery" and no "captive" customers such as home agencies.

## **B. So What's the Big Deal About Costs?**

As discussed previously, under the CFO Act and GPRA, the federal government is moving inevitably towards an accounting system that will allow it to track all of its costs at the responsibility center level. In accounting parlance, costs are allocated or assigned to "cost objects" that are typically activities or items whose cost is to be measured.

In a broad sense, a cost object can be an organizational division, program, activity, task, product service, or customer. However, the purpose of cost accounting by a responsibility segment is to measure the costs of its outputs. Accordingly, the final cost objects of a responsibility segment are its outputs: the services or products that the segment produces and delivers, the missions or tasks that the segment performs, or the customers or markets that the responsibility segment serves.<sup>45</sup>

The JFMIP explains that there are four costing methodologies that can be used to assign costs to a responsibility segment: activity-based costing, job order costing, process costing, and standard costing.<sup>46</sup> These costing methodologies are not mutually exclusive. Both activity-based costing and standard costing can be applied to job order or process costing systems.

## **C. Comparing Public Sector and Private Sector Accounting Theories**

What the accounting guidance does not do is define the boundaries of a responsible segment. Where do you draw the line for the purposes of assigning costs? Should a business unit involved with base operations at an Army installation in Arkansas be allocated the costs of operating the Pentagon? Should it be allocated the costs of supporting troops in Bosnia? Should it be allocated the costs of operating Air Force One?

There are many in the private sector who would argue that all costs of government should be allocated to each segment. Otherwise, how else can one fairly compare the costs for the government to perform a particular activity to the costs for a private company to perform that same activity? In support of this argument, they first refer to Generally Accepted Accounting Principles (GAAP), which require measuring a whole business for an entire accounting period.<sup>47</sup> These standards are used primarily by independent Certified Public Accountants (CPAs) in making determinations of the reasonableness of a company's balance sheet for the whole business and income statement for the whole business for an entire accounting period. Next they refer to the discipline of cost accounting which is that part of accounting which accounts for segments of a company's activities. Financial accounting is that part of

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affecting financial operations and organizations, and any other financial management matter."

<sup>45</sup> See JOINT FINANCIAL MANAGEMENT IMPROVEMENT PROGRAM, FFMSR-8, SYSTEM REQUIREMENTS FOR MANAGERIAL COST ACCOUNTING.

<sup>46</sup> See *id.*

<sup>47</sup> See *generally* AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AUDITS OF FEDERAL GOVERNMENT CONTRACTORS 38 (1990).

accounting that deals with the whole of the company for a whole accounting period.<sup>48</sup> Cost accounting is a logical extension of financial accounting as it controls the assignment of those expenses and revenues to accounting objectives within the company.<sup>49</sup> For example, financial accounting controls how a company's depreciation expense for the year is computed. Cost accounting controls how that depreciation expense is assigned to the various segments of the company.

There are three main characteristics of a cost accounting system: (1) it provides a mechanism for recording the total cost of transactions (this is a characteristic of a financial accounting system as well); (2) it provides a basis for distributing the total cost measure of those transactions to the defined cost objectives; and (3) it provides data for the financial accounting system.<sup>50</sup> Based on this language, it is clear that private contractors must account for all costs of the business and allocate those costs within the strictures of GAAP's financial and cost accounting principles.

In addition to being subjected to GAAP, government contractors are also subject to the rules of the Federal Acquisition Regulations (FAR), including those involving costs.<sup>51</sup> Larger government contractors are also subject to the Cost Accounting Standards (CAS).<sup>52</sup> Under the FAR and CAS, contractors must account for all costs. In so doing, individual contractors have choices in developing accounting systems, including ways of differentiating between direct and indirect costs, selecting the number and content of overhead cost pools, and picking the method of allocating these overhead costs to cost objectives.<sup>53</sup> Again, these rules require that all costs be considered and treated consistently.<sup>54</sup>

Difficulties arise when attempts are made to compare private sector and public sector entities' indirect costs. With respect to direct costs, there usually is no difficulty. The Federal Acquisition Regulations define a direct cost as any cost that can be identified specifically with a particular final cost objective.<sup>55</sup> They normally include the salaries and wages of performance or management personnel directly associated with these cost objectives; also included are associated fringe benefits, materials directly used in providing the service or product, and subcontract costs related to the cost objective.<sup>56</sup> The rules governing public sector accounting generally follow this logic, and, therefore, as previously indicated, there is usually little room for disagreement.

Turning to indirect costs, these are all costs that cannot be specifically identified with units of output at the time they are incurred because cost either is incurred for more than one unit of output or is not susceptible to measurement at the unit of output.<sup>57</sup> Indirect costs are

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<sup>48</sup> See *generally* HOWARD W. WRIGHT & JAMES P. BEDINGFIELD, GOVERNMENT CONTRACT ACCOUNTING 87 (1979).

<sup>49</sup> See *id.*

<sup>50</sup> See *id.*

<sup>51</sup> See FAR Subpart 31 ("Contract Cost Principles and Procedures")

<sup>52</sup> See *generally* FAR Appendix -- Cost Accounting Standards Preambles and Regulations, Pt. 9904.

<sup>53</sup> See *id.* at § 9904.401; see also DELOITTE & TOUCHE, BASIC COST ACCOUNTING CONSIDERATIONS IN GOVERNMENT CONTRACTING 126-28 (1990).

<sup>54</sup> See *id.*

<sup>55</sup> See FAR § 31.202.

<sup>56</sup> See *id.*

<sup>57</sup> See *id.* at § 31.203(a).

commonly separated into overhead and General and Administrative (G&A) costs.<sup>58</sup> Overhead costs are those not directly related to cost objective but are support-type costs necessary for normal operations, such as expenses for salaries and wages of support and administrative personnel, facilities expenses, and general supplies.<sup>59</sup> Overhead costs may be accumulated into overhead pools.<sup>60</sup> The number of pools can vary depending on the complexity of operations. Each overhead pool is allocated to cost objectives in reasonable proportion to the beneficial or causal relationship of the pooled costs to cost objectives. G&A costs are any management and other expense that is incurred by or allocated to a business unit and is for the general management and administration of the business unit as a whole.<sup>61</sup> G&A costs normally include compensation of executives and their related fringe benefits, legal and professional fees, and other administrative personnel and costs.<sup>62</sup> G&A costs are frequently accumulated in a single pool and allocated to the entire business unit based on the total cost by way of a prescribed rate.

The above language on indirect costs comes from the FAR and applies to government contractors.<sup>63</sup> The question is whether it can or should apply to government agencies. As a matter of course, these "pools" do not exist in today's public sector accounting systems -- yet. They will emerge as compliance with the CFO Act occurs. When one is engaged in an A-76 cost comparison process, costs are allocated for comparison purposes; but otherwise these pools do not exist for accounting or budgetary purposes. An even more important issue is how best to identify these costs on the government side of the ledger when conducting a fair cost comparison. Two central issues arise: First, how do you define a government business unit? The private sector by necessity has to include the entire enterprise regardless of size and then break it down into various business segments or lower echelon business units. The government does not have to be as inclusive. Because it is not a business enterprise and consists of sovereign functions, there are some elements that cannot and should not be outsourced (i.e. inherently governmental). Second, how do you handle the issue of idle labor and idle facilities? DOD has excess capacity now, and as ISSAs pursue new work, in competition with the private sector, can the ISSAs tap into this capacity for bidding, purposes as an unpriced asset?

#### **D. The Kelly Air Force Base Competition**

This was a central issue - even the dispositive issue - in the recent Privatization-In-Place competition that occurred at Kelly Air Force Base in San Antonio last year. (It is important to note that the Kelly depot base closing privatization decision was not subject to A-76.) Historically, the Air Force considered the capacity to maintain and repair its most vital equipment as too critical to its mission to allow outside of its direct control. However, with the five Air Logistics Centers (ALC) operating at less than 50% capacity, it became clear that some facilities would have to close despite the Air Force's arguments that it needed this organic capacity in case of a surge in military activity. In 1995, against Air Force advice, the

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<sup>58</sup> See *id.* at § 31.203(b).

<sup>59</sup> See *also* BASIC COST ACCOUNTING CONSIDERATIONS IN GOVERNMENT CONTRACTING, at 153-54.

<sup>60</sup> See *generally* Donald S. Grenough & Nelson H. Shapiro, Understanding Overhead in Government Contracts 73-84 (1983) (Chapter 10, "Indirect Cost Pools").

<sup>61</sup> See *also* FRANK M. ALSTON, MARGARET M. WORTHINGTON & LOUIS P. GOLDSMAN, CONTRACTING WITH THE FEDERAL GOVERNMENT 213-15 (1992) (examining Cost Accounting Standard 410).

<sup>62</sup> See *id.*

<sup>63</sup> See FAR § 31.203.

Base Realignment and Closure Commission (BRAC) decided that the ALCs at McClellan and Kelly Air Force Bases should be closed and the work reallocated among the remaining ALCs in Oklahoma, Utah, and Georgia. This triggered immediate consternation not only within the Air Force but also the White House, which was concerned about the loss of jobs in California and Texas. There were more than 11,000 civilian workers employed at McClellan near Sacramento and more than 14,000 were employed at Kelly.

To avoid political repercussions, the Administration hit upon the notion of Privatization-in-Place. Jeremy Shapiro wrote that Privatization-in-Place essentially means selling assets of the Kelly depot in exchange for a promise that certain personnel levels will be maintained for specified periods of time.<sup>64</sup> Mr. Shapiro also stated that similar privatizations were being implemented at the Air Force's Aerospace Guidance and Meteorology Center in Newark, Ohio; the Naval Warfare Center in Indianapolis; and the Navy Gun Center of Excellence in Louisville, Kentucky.<sup>65</sup>

In fact, Mr. Shapiro stresses that privatization-in-place offers several advantages for both the politicians and the military. For the politicians, privatization-in-place offers an alternative to the unpleasant consequences of BRAC decisions without violating the letter of the BRAC requirements.<sup>66</sup> For the military, it allows it to at least maintain a proven surge capacity and perhaps to save some of its budget for modernization instead of repair.<sup>67</sup>

When the competition was conducted, the winner between the competing private sector offers and the Air Force offer from Warner-Robbins Air Force Base in Georgia turned out to be Warner-Robbins. The Air Force won, and the work remained in-house - but in Georgia, not San Antonio. So, the workers in San Antonio lost. Had the work gone to one of the private contractors offering to perform the work, the Air Force would have "lost" but the work would have stayed in San Antonio. On the other hand, excess capacity was eliminated, economies of scale prevailed, and the union was pleased with the result. When all was said and done after the inevitable challenges, it turned out that the Air Force did not include the cost of idle facilities or labor at Warner-Robbins in calculating its costs. Were it a private contractor subject to GAAP and CAS, it is hard to imagine how the contractor could avoid including such costs into its cost proposal for fear, at least, of dire audit consequences. Had the Air Force fully accounted for idle labor and facilities properly, the outcome of the competition may very well have been different - and this especially would have been the case had the rules of A-76 applied, especially in light of the FAIR Act.

To give this some balance, there are those who maintain that the numbers can be rigged to make privatization and outsourcing appear more attractive than they should. For example, take the case of Newark Air Force Base, Ohio, where in 1993 the Air Force announced it would close the base and privatize-in-place the navigational guidance repair work conducted by 1,400 workers at the facility. GAO looked at the Air Force's projected one-time closing cost and projected that it had doubled. Writing in the Government Executive in December 1995, James Kitfield said:

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<sup>64</sup> Jeremy Shapiro, *Privatization-in-Place*, BREAKTHROUGHS: THE RESEARCH JOURNAL OF THE MASSACHUSETTS INSTITUTE OF TECHNOLOGY SECURITY STUDIES PROGRAM (Spring 1998).

<sup>65</sup> See *Id.*

<sup>66</sup> See *id.* President Clinton claimed that privatization-in-place would retain at least 8,700 jobs at McClellan and 16,000 jobs at Kelly through 2001.

<sup>67</sup> See *id.*

In fact GAO concluded that contracting out the work at Newark might actually cost \$456 million more over the next five years than having the Air Force do it...[David Warren, a GAO investigator, stated] ... For instance ... the Air Force used models based on outright base closure to calculate savings, and therefore equated personnel costs to now-recurring costs. When those personnel costs started recurring as a payment to a private sector company, the projected savings figure declined, and took years longer to realize.

There are other examples that reflect the disconnect between public sector and private sector accounting methodologies which lead to distorted results. The case of Pemco Aeroplex, Inc., decided by the General Accounting Office in a bid protest denial, illustrates the point.<sup>68</sup>

In July 1996, the Air Force issued a request for proposals for programmed depot-level maintenance for the C-130 in Europe, the continental United States, and the Pacific. In April, it awarded a contract for the United States to Aero Corp. and Pemco protested. The GAO ruled in favor of Pemco based on a finding that the Air Force's past performance analysis was inadequate, and the Air Force decided to have the work performed in-house by Warner-Robbins Air Logistics Center on a temporary basis. This turned into a more permanent arrangement when the Air Force announced in March 1998 that it was canceling the RFP and dividing the work in-house between Warner-Robbins and Ogden Air Logistics Center in Utah.

Pemco and Aero protested this decision to the GAO contending that the cancellation was based on a flawed business case analysis and that the Air Force could not perform the work less expensively than could either of the private contractors. Although the Air Force's action was not undertaken pursuant to an official A-76 announcement and methodology, the Air Force claimed that it essentially followed certain aspects of an A-76 cost analysis in arriving at a determination that the Air Force could perform the work at a cost lower than could the private sector. On closer examination, however, it is clear that the Air Force did not follow the A-76 cost comparison process. The Air Force was also subject to the provisions of 10 U.S.C. 2462 that requires DOD to procure supplies and services from the private sector if doing so would result in a lower cost.

The GAO did not reach the question of whether the cost comparison was flawed despite a clear showing by the protestors that the Air Force did not include all relevant costs for Warner-Robbins and Ogden when calculating the total costs for the Air Force. Had GAO been required to deal with this question directly, it is almost a certainty that the GAO would have sustained Pemco's protest. Instead of dealing with the cost question directly, the GAO was able to resolve the case by focusing entirely on another provision, 10 U.S.C. 2466a, which limits to 50%<sup>69</sup> the amount of depot-level work that can be contracted out to the private sector in any given fiscal year. Under the facts presented, the GAO agreed with the Air Force that for FY 1998, \$3.112 billion is provided to public depots and \$2.503 billion is provided to private contractors resulting in a difference of roughly \$600 million. A shift of \$300 million from the public sector to the private sector would potentially place the Air Force in violation of Section 2466a.

Despite this ruling, it is noteworthy that in examining the Air Force's own cost methodology, Aero was able to demonstrate that certain idle facility and idle labor costs (reflecting excess capacity and people who would perform some of the work brought in-house) were not included in the Air Force's costs. Hence, when Aero's and Pemco's costs (which had to include all

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<sup>68</sup> See *Pemco Aeroplex Inc.*, 98-2 CPD ¶ 17, B-275587.9 (June 29, 1998).

<sup>69</sup> The limit used to be 40 percent.

costs to perform the work including the facilities and labor that the Air Force did not consider) were totaled, the Air Force's costs looked cosmetically lower.

The bottom line is that the Air Force made a decision to bring certain C-130 aircraft maintenance work in-house using a cost comparison methodology that did not include all of the costs for idle facilities and idle labor. The Air Force's logic for not including those costs is that as a military service it has to have a standby capability to handle wartime surge situations and that it is unfair to penalize a maintenance business unit by having to carry these sustaining-type costs. A-76 permits certain work to be retained in-house and not be exposed to cost comparison; but once a decision is made to conduct a cost comparison, the rules call for "a fair and level playing field." The private sector parries that argument by pointing to the rules governing costing and maintain that the government cannot have it both ways. If it is acting as a sovereign that has national defense responsibilities, then it should stay away from the competitive marketplace that has its own accounting rules calling for full costing and fair disclosure on a level playing field. If it is acting as an entrepreneurial center of government in the marketplace, it has to be subjected to the same rules that private sector firms must meet.

### **E. What is the Appropriate Accounting Approach?**

These examples frame a critical accounting debate over how to consider costs when comparing costs between in-house and contracted services at military installations. The accounting literature recognizes three types of costs to consider: Fully allocated, avoidable, and marginal.

An in-house fully allocated (or total) cost, which has been discussed at length above, is the sum of the direct costs for the cost object plus a proportional share of organizational overhead (or indirect costs). Direct costs include salaries wages, and ODCs as well as item routinely overlooked such as interest costs, pension costs, and facility and equipment costs. Overhead costs are generally apportioned among government services, programs and activities according to some allocation scheme. The most common methods are based on headcount, total direct costs, and the "step-down" method. The headcount method assumes that overhead is proportional to the number of employees. The total direct method assumes overhead is proportional to the budget of the target service. The step-down method divides all departments into either support or production departments and allocates all the costs of support departments to the other entities they serve.

The total cost of contract service delivery is the sum of the contractor's costs (its proposed price), plus contract administration costs, plus an allowance for one-time conversion costs, and minus off-setting revenues (new or enhanced revenue streams that will come to the government as a result of contracting out a target service such as new taxes).

According to Lawrence Martin writing in March 1993 for the Reason Foundation:

[Use of fully allocated costs] are appropriate in evaluating the operating efficiency of a public provider. Comparing the fully allocated cost of the in-house provider with the anticipated total cost of contracting is useful in assessing their relative efficiency. If the fully allocated costs of the public provider are more than ten percent greater than for a private contractor, that service merits further consideration for [outsourcing]. Fully allocated costs, however, are not the correct measure for estimating the likely cost savings through [outsourcing], as fully allocated costs tend to overestimate savings, especially in the short term.

The use of fully allocated costs is generally inappropriate in estimating savings between the fully allocated in-house costs and the total contracting cost. This is because contracting out does not generally result in a dollar-for-dollar reduction in governmental overhead costs. For example, the contracting out of a target

service, or portion thereof, may result in decreasing the workload of service departments like personnel, finance, and facilities management; but the workload reductions may be insufficient to have any significant effect on the costs of maintaining these departments.<sup>70</sup>

Avoidable costs are those in-house costs that will not be incurred if a target service, or portion thereof, is outsourced. Virtually all direct costs are avoidable, but it is much more difficult to determine avoidable overhead costs. Mr. Martin observes:

How-to contracting books, as well as several contracting-out guides prepared by state and local governments, recommend the use of avoidable costs when assessing the likely cost savings achievable through contracting out. The use of avoidable, or incremental costs is also the generally accepted managerial accounting approach to conducting the financial component of a business "make-or-buy" decision.<sup>71</sup>

The difficulty with avoidable costs is that the private sector usually responds rapidly in reducing overhead when direct costs fall, whereas the public sector is not as nimble for a variety of reasons which include civil service protection and institutional inertia. Being driven by the bottom line, private entities need to react quickly whereas public sector entities rely on appropriated sums. In addition, organizations do not realize avoidable costs unless a substantial amount of the target service is outsourced. If there are only small amounts of work involved, there will be a negligible impact on overhead. Moreover, there may be costs that can be avoided in the long term but which must be incurred in the short term.

Given these limitations, the literature still suggests that cost savings using the avoidable cost theory is the preferred methodology to follow in measuring overhead savings. Indeed, as will be discussed below, A-76 has adopted this methodology for measuring costs under the federal-managed competition program.

A third approach is marginal costing. A business entity planning to enter a new line of business has the choice to provide the work in-house or to contract out for it. This "make-or-buy" decision is traditionally examined in the context of marginal costing which calls for the additional cost of providing the service in-house to be compared to the total cost of purchasing the service. Again, Mr. Martin observes:

But what is sound business practice is not necessarily prudent for government entities, which do not operate in a competitive environment. For this reason, state and local governments desiring to promote public-private sector competition may find that basing in-house bids and proposals on fully allocated costs comes closer to creating a "level playing field." This is because, unlike a competitive enterprise, a public provider often maintains excess productive capacity. Business accounting theory assumes an efficient allocation of resources, and this assumption is often not valid for monopolistic public providers. The existence of surplus capacity in public providers tends to make estimates of the marginal cost unrealistically low. Assuming that an in-house department has surplus capacity and bids to perform a new service using incremental cost rather than fully allocated cost it is difficult to imagine many scenarios in which a private-provider cost would appear competitive.

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<sup>70</sup> Lawrence Martin, *How To Compare Costs Between In-House And Contracted Services*, How-To Guide No. 4, Reason Public Policy Institute (March 1993).

<sup>71</sup> *Id.*

This is true even for private providers that are far less expensive. The practice of comparing in-house marginal cost with the total cost of contracting has the practical effect of precluding private contracting. Therefore, in the case of new or significantly expanded service, governments wishing to promote competition should compare the fully allocated costs of the government agency against the total cost of the contracted service.<sup>72</sup>

To add to the complexity, keep in mind that there are traditionally four different methods for conducting make-or-buy decisions: net present value (NPV), internal rate of return (IRR), payback period, and accounting rate of return.<sup>73</sup>

The preferred method is NPV. The first step is to calculate the net cash flow generated by the project, starting with project revenues and subtracting expenses (other than depreciation), capital expenditures, and taxes. The net present value is the benefit that accrues to the organization from buying the specific equipment. It is the sum of the present values of all future cash flow minus initial cost. A positive net present value means that the project yields a rate of return that exceeds the cost of capital; a negative net present value means that the project earns less than the entity could obtain by keeping the money in the bank.

The IRR method looks only at the rate of return on the project. If the IRR is high, this is good. If it is low, the project may not go forward. If the IRR from the project is higher than what could be generated from a bank's interest rate for the cash flow involved, then there is a financial basis for going forward. The IRR method is not as good as the NPV method because selecting an alternative with the highest IRR is illusory. If one project has an IRR of 10 percent and another has a rate of 40 percent, the 10 percent project may still be the better approach when absolute dollar returns are taken into account

The payback method is the length of time it takes to recover the initial investment. The payback period method postulates acceptance of a project payback only if the payback occurs more quickly than a predetermined timeframe. The one with the shortest payback period wins.

The accounting rate of return method, also called the return on investment (ROI), is the average annual after-tax accounting profit generated by the investment divided by the initial expense. This method is inferior to the NPV because it does not evaluate cash flows or take into account the cost of money.

## **F. The Bottom Line On Costs**

So, having run through all of these rules and their complexities, what is the bottom line on costs? Clearly, there is a disparity in the way we approach costs; but there has been little reasoned discussion about the complexity in accounting methodologies as applied to our federal managed competition program regardless of whether the competitions occur under A-76 or not. Hence, when following the evolution of the cost related language in the FAIR Act there are many who are concerned that the measure's language only appears to be dealing with total costs and that it covers all types of public-private-ISSA transactions. It fails to address the issue of capacity or the way in which differing

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<sup>72</sup> *Id.*

<sup>73</sup> DANIEL MINOLI, ANALYZING OUTSOURCING: REENGINEERING INFORMATION AND COMMUNICATION SYSTEMS 90-92 (1995). Mr. Minoli works at New York University's Information Technology Institute.

accounting approaches should be reconciled for fair cost comparison purposes as a matter of public policy. Is there a difference between military and non-military agencies when it comes to retaining underutilized assets and personnel? It doesn't address which type of accounting methodologies should be used under what circumstances. It does not address whether there should be separate accounting methodologies to use in make-or-buy determinations and, if so, which one is preferred. There are a host of questions like these which need to be tackled in an intelligent, reasoned context. With this in mind, the full text of the language in the FAIR Act is worth examining:

Section 2 (e) Realistic and Fair Cost Comparisons. - For the purpose of determining whether to contract with a source in the private sector for the performance of an executive agency activity on the list on the basis of a comparison of the costs of procuring services from such source with the costs of performing that activity by the executive agency, the head of the executive agency shall ensure that all costs (including the costs of quality assurance, technical monitoring of the performance of such function, liability insurance, employee retirement and disability benefit, and all other overhead costs) are considered and that the costs are realistic and fair.<sup>74</sup>

While the language is helpful, it could go much further -- not by presenting a legislative laundry list of accounting rules but by creating a process for a uniform set of accounting rules to be used whenever public sector and private sector costs are examined in the context of a competitive cost comparison. Either GAO or OMB could step in to control the process and involve the JFMIP, the FASAB, and the CAS Board while wrestling with these issues collectively along with the best accounting minds from the public and private sectors? They could come back to the Congress or OMB with recommendations within a relatively brief timeframe, and then decisions can be made on fundamental public policy cost matters in a way that engenders trust in a truly "realistic and fair" competitive process. To its credit, OMB has played a significant role in shaping the legislation and creating a workable cost comparison process. Now it is time to move ahead with implementation.

In arriving at the new cost comparison rules under the March 1996 Supplemental Handbook, OMB made a serious attempt to create a level playing field in the cost arena. It has chapters dealing specifically with how to handle ISSA participation in the process,<sup>75</sup> how to prepare cost comparison estimates for government performance and contract performance,<sup>76</sup> how to conduct streamlined cost comparisons for activities below a specified FTE threshold,<sup>77</sup> and overall A-76 methodology. However, when it comes to dealing with the major open issues (such as idle capacity and labor, or which accounting theory to apply under what circumstances), some argue that the drafters did not go beyond the accounting standards discussed above. The Administration disagrees with these critics, saying that A-76, if used properly, does take these costs into account; it all depends upon implementation.

To the drafters' credit, they attempted to move towards the full allocation of cost method as much as was practical:

Competitions based upon output and cost performance measures must reflect the agency's fully allocated costs of performance and must be certified as being

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<sup>74</sup> See Federal Activities Inventory Reform Act, Pub. L. No. 105-270, § 2(e), 112 Stat. 2382.

<sup>75</sup> See OMB Circular A-76 -- Revised Supplemental Handbook, at 8-10 (Part I, Chapter 2).

<sup>76</sup> See *id.* at 10-14 (Part I, Chapter 3).

<sup>77</sup> See *id.* at 3 (Part I, Chapter 1(C)(6)).

in full compliance with the Statement of Federal Accounting Standards No. 4, "*Managerial Cost Accounting Standards for the Federal Government*." The cost comparability procedures described in this Supplement such as those related to fringe benefit factors, must also be considered in assessing the comparability of Government and private sector performance measures and costs. Adjustments to Government and private sector performance measures and costs may be required. Performance standards should be monitored in conjunction with the Chief Financial Officers Act (CFO Act) and the Government Performance Results Act of 1993 (GPRA).<sup>78</sup>

. . . A cost comparison between in-house, contract or ISSA performance seems straight-forward, but in fact is complicated by the very different ways Government agencies and commercial sources account for cost. For example, the Government buys capital equipment and may recognize the entire expense when payment is made. The commercial sector may borrow funds and recognize the expense of capital equipment as it is used. All costs incurred by commercial sources are ultimately charged to a "customer," whereas agency costs may be met by several different appropriations accounts, revolving funds or mixes thereof. Insurance is a real cost of doing business in the commercial sector, while the Federal Government is a "self-insured entity." Taxes are paid by most commercial sources and received and used by the public sector. Assets are purchased from owners in the commercial sector, yet they are purchased by the taxpayer in the public sector. The Government may incur employee retained pay or save pay as a way of mitigating the adverse impacts of a management decision, without assessing these costs to the activity. The commercial sector passes these types of costs on to the customer. These and other differences necessitate cost comparison requirements that equalize the systems to reflect the total alternative costs to the Government and the taxpayer. Such costs may or may not be fully reflected by agency accounts.<sup>79</sup>

Although this straightforward recognition on OMB's part that it has been unable to treat similar costs in a similar fashion due to the differences between public sector and private sector accounting methodologies is refreshing, it does not completely overcome some of the larger gaps in accounting logic. For example, the situation is clearly illustrated by turning to the treatment of overhead in the Supplement. The Supplement lumps operations overhead<sup>80</sup> and G&A overhead together.<sup>81</sup> The Supplement states that personnel costs "may include certain management and oversight activities, such as personnel support, environmental or OSHA compliance management legal or other direct administrative support costs."<sup>82</sup> These costs are to be entered in Line 1 of the Generic A-76 Cost Comparison Form (CCF). The Supplement provides that overhead costs are to be entered in Line 4 of the CCF and requires that these costs be calculated as a flat 12% of Line 1. The Supplement defines overhead as consisting of two parts. The first is operations overhead which are those costs that are not 100 percent attributable to the activity under study. The second is general and administrative (G&A) and includes salaries, equipment space and other activities related to headquarters

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<sup>78</sup> See *id.* at 3-4 (Part I, Chapter 1(C)(7)(b)).

<sup>79</sup> See *id.* at 17 (Part II, Chapter 1(A)(3)).

<sup>80</sup> "Operations overhead" is defined as those costs not 100 percent attributable to the activity under study. See OMB Circular A-76 -- Revised Supplemental Handbook, at 23.

<sup>81</sup> See *id.* at 20.

<sup>82</sup> See *id.*

management, accounting, personnel, legal support, data processing management and similar common services performed outside the activity, but in support of the activity.

This is helpful language as far as it goes, but it does not draw the line in the same way that government contractors are forced to do under Cost Accounting Standard (CAS) 410.<sup>83</sup> CAS 410 deals with G&A expenses and the allocation of "business unit general and administrative expenses to final cost objectives."<sup>84</sup> This is a dry way of describing how "home office" costs, such as centralized services, staff management of specific activities, central payments, and the like, are equitably distributed among all of the business segments of the enterprise. Contrary to the flexibility allowed by the Supplement in deciding how much of the costs got allocated to a business unit,<sup>85</sup> the private sector is subjected to the strict and rigid requirements of the Cost Accounting Standards. Hence, the public sector can decide on a case-by-case basis which costs are included in G&A and which are not for cost comparison purposes. On the other hand, CAS 410 requires consistency in all circumstances, thereby handcuffing government contractors with the use of prescribed allocation formulas.<sup>86</sup> This is accomplished typically through the use of the total cost input basis of arriving at G&A, which is the generally acceptable measure of the total activity of the business unit. However, CAS 410 allows several alternatives such as value-added and single-element cost input.<sup>87</sup> Regardless of which methodology is chosen, once a government contractor has fixed on a particular methodology, it cannot change without going through the costly and time-consuming process of making a formal cost accounting change complete with filing a revised accounting disclosure statement and cost impact analysis. No government agency faces such a restriction or penalties for CAS noncompliance.

In addition, Cost Accounting Standard 418 constrains government contractors in the way that they determine, accumulate, and allocate direct and indirect costs.<sup>88</sup> Each business unit of a company must have a written statement of accounting policies for classifying costs as either direct or indirect. Indirect costs must be accumulated in homogenous cost pools in which all significant costs have similar beneficial or causal relationships to cost objectives.<sup>89</sup> Again, government contractors have some flexibility in deciding upon its allocation methodology. For example, the basis used for allocation depends on the type of costs included in the pool. If the cost pool consists primarily of managing direct labor activities, a direct labor hour or dollar base would be appropriate. If pool costs were primarily facility-related, such as depreciation, maintenance, or utilities, a machine hour base would be appropriate. However, once the rules on what is a direct cost versus and indirect cost is set and the allocation methodology established, the company cannot change them without going through the process described above.

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<sup>83</sup> See *generally* FAR Appendix -- Cost Accounting Standards Preambles and Regulations at § 9904.410.

<sup>84</sup> See *id.*

<sup>85</sup> Note that the Supplement requires that only "certain" costs "may" get included in Line 1 and that this can vary from business unit to business unit even within the same agency or service. See OMB Circular A-76 -- Revised Supplemental Handbook, at 20.

<sup>86</sup> See FAR Appendix -- Cost Accounting Standards Preambles and Regulations at § 9904.410

<sup>87</sup> See *id.*

<sup>88</sup> See *id.* at § 9904.418.

<sup>89</sup> See *id.*

In contrast, public entities are not so constrained in the way that they can move costs back and forth from direct to indirect on a situational basis within an agency or service. Therefore, they can treat each new competitive situation differently to keep direct and indirect costs cosmetically low for bid or proposal competitive purposes. This means that cost pools can vary on a situational basis and the allocation methodologies can be skewed to the advantage of the government unless care is taken by internal government reviewers to keep the process honest and consistent. It is especially difficult to police in the case of ISSA's which do not file Disclosure Statements analogous to what government contractors are required to submit and, therefore, can present costs to agencies not familiar with the way an ISSA handled similar costs in similar circumstances with another agency. The closest that the public sector has to govern this area of potential mischief are agency financial statements, but they do not approach the level of detail that CAS requires. Moreover, they certainly do not have penalties for noncompliance that begin to approach what government contractors face under CAS.

Aside from the differences in handling overhead matters, the A-76's Revised Supplemental Handbook's accounting resorts to use of the avoidable cost method for determining the cost savings to be realized should the activity be contracted-out. This is done by multiplying the costs of personnel, including fringe benefit by 12 percent. Significantly, the Supplement applies this formula to all circumstances even though others would argue that there are circumstances, as discussed above, where fully allocated costing or marginal costing are more appropriate. This takes us back to the central issues of idle labor and idle capacity that drove the decisions in ICEMAN, Kelly Air Force Base, and the Aero/Pemco protest. As Mr. Martin pointed out in his Reason Foundation paper discussed above:

When attempting to determine the potential cost savings associated with the contracting out of a target service, the appropriate in-house costs to use in the comparison are the "avoidable costs" [which are] those in-house costs that will not be incurred if a target service, or portion thereof, is contracted out. [However, when looking at a situation where an agency is seeking to expand its business base, such as in the case of an entrepreneurial ISSA, it is more appropriate to use fully allocated costs.] Business accounting theory assumes an efficient allocation of resources, and this assumption is often not valid for monopolistic public providers. The existence of surplus capacity in public providers tends to make estimates of the marginal cost unrealistically low. Assuming that an in-house department has surplus capacity and bids to perform a new service using incremental cost rather than fully allocated cost it is difficult to imagine many scenarios in which a private-provider cost would appear competitive. This is true for private providers that are far less expensive. The practice of comparing in-house marginal costs with the total cost of contracting has the practical effect of precluding private contracting. Therefore, in the case of new or significantly expanded service [as in the case of an ISSA situation], governments wishing to promote competition should compare the fully allocated costs of the government agency against the total cost of the contracted service.<sup>90</sup>

Another area of strong controversy revolves around the treatment of bid and proposal costs. Cost Accounting Standard 420 provides clear rules about identifying, tracking, and recording

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<sup>90</sup> See Lawrence Martin, *How To Compare Costs Between In-House And Contracted Services*, How-To Guide No. 4, Reason Public Policy Institute

B&P costs.<sup>91</sup> Commercial companies must account for them in their costs and prices. It sometimes costs hundreds of thousands of dollars or more for a commercial offeror to assemble a proposal in response to an A-76 opportunity. Yet, government agencies do not have to include the costs of their B&P into their cost or price considerations. The only language in the Supplement that comes close to addressing this issue appears in Chapter 2 where OMB states that "[t]he cost of conducting a cost comparison is not added to the in-house cost estimate or contract price."<sup>92</sup> OMB maintains that B&P Costs are included in the 12 percent overhead rate, but many would argue that 12 percent is far too low a number to begin with to allow a cost as significant as S&P to be embedded in that rate. Perhaps, with the new authority given it OMB may consider addressing the issue and modifying the Supplement to account for this disparity, especially in the case of ISSAs.

## **V. The Future of A-76**

The 104<sup>th</sup> Congress adopted an amendment to the fiscal year 2001 defense authorization bill that will require the GAO to study the way the federal government selects sources -- whether public or private sector -- to perform commercial or industrial functions under OMB Circular A-76.<sup>93</sup> The provision requires the GAO to convene a panel of experts "to study the policies and procedures governing the transfer of Government commercial activities from Government personnel to a Federal contractor."<sup>94</sup> The panel will be chaired by the Comptroller General. An opportunity to provide input to the panel would have to be given to all interested parties, including government employees, members of private industry, and representatives of federal labor organizations.<sup>95</sup> Finally, the GAO would have to report to Congress on the panel's findings.<sup>96</sup>

When Congress passed the FAIR Act in 1998, it basically asked the GAO to perform this type of analysis.<sup>97</sup> Hopefully, this more recent directive from Congress will prompt the GAO to consider, in addition to studying "the general policies and procedures governing the transfer of Government commercial activities from Government personnel to a Federal contractor," the cost issues identified in this article. Without first addressing the fundamental differences between how costs are handled by the public and private sector, any analysis of the procedures that build upon costs will be elusive.

## **PART TWO: ALTERNATIVES TO A-76**

### **I. ESOPs**

#### **A. Introduction**

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<sup>91</sup> See FAR Appendix -- Cost Accounting Standards Preambles and Regulations at § 9904.420.

<sup>92</sup> See Circular No. A-76 -- Revised Supplemental Handbook, at pt. II, ch. 2(A)(5).

<sup>93</sup> See National Defense Authorization Act 2001, Pub. L. No. 106-398, § 832 (2000); see also *Senate Calls for GAO Review of Circular A-76 Contracting Out Process*, Fed. Cont. Rep. (BNA), Vol. 74, No. 1 at 8 (July 4, 2000).

<sup>94</sup> *Id.*

<sup>95</sup> See *id.*

<sup>96</sup> See *id.*

<sup>97</sup> See Federal Activities Inventory Act, Pub. L. No. 105-270.

Getting back to our individual who is confronting the prospects of engaging in the A-76 process, he or she is very likely to want to know about other reasonable alternatives that may be available to pursue. By its own terms, the OMB Supplemental Handbook calls for subjecting activities to cost comparison competitions only when the activities are recurring in nature. Nonrecurring commercial activities are to be procured through contracts with the private sector. This language is particularly instructive as it pertains to privatization which OMB defines as follows:

Privatization is the process of changing a public entity of enterprise to private control and ownership. It does not include determinations as to whether a support service should be obtained through public or private resources, when the Government retains full responsibility and control over the delivery of those services.<sup>98</sup>

One method of privatization that is gaining attention is the Employee Stock Ownership Plan (ESOP).<sup>99</sup> The ESOP mechanism is used to spin-off existing government activities and employees into a new ESOP company. ESOP companies are well established with about 12,000 of them in the U.S. economy employing roughly 15 million people. Some of the more notable ones are AVIS and United Airlines. In government contractor circles, SAIC and Dyncorp are well known ESOP companies.

The ESOP mechanism is attractive to government employees who are confronted with the prospect of being subjected to an A-76 cost comparison study. It gives them the ability to take control over their own destiny, and it gives them a stake in the successful outcome of a new business. When ESOPs work, they can provide public sector employees with the fabled "soft landing" that all displaced workers covet.

ESOP transactions can be structured in a variety of ways ranging from a "standalone" approach to much more complicated arrangements that challenge even the most sophisticated merger and acquisition specialist. There are a multitude of issues to handle, and public sector employees are well advised to seek expert assistance in attempting any ESOP transaction. Fortunately, there are a few recent examples to follow, and there are many more now in the transaction pipeline.

## **B. The USIS Precedent**

The precedent setting ESOP transaction involved the Office of Federal Investigations in the Office of Personnel Management (OPM).<sup>100</sup> Then OPM Director James King led the effort to privatize the operation into a new ESOP company now known as United States Investigations Services, Inc. (USIS). Each of the 700 USIS employees holds USIS stock in ESOP accounts that form the primary basis for the company's pension plan and traditional 401(k) plan. Thus, as USIS does well, so do the employees. The converse is also true, so the employees are motivated to see that USIS is successful and that its net worth increases.

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<sup>98</sup> See *id.* at 37 (app. 1).

<sup>99</sup> See generally The ESOP Association, << <http://www.the-esop-emplowner.org/> >>.

The ESOP Association is a national membership organization with a primary focus on employee ownership through employee stock ownership plans (ESOPs).

<sup>100</sup> See generally American Capital Strategies, *First-Ever ESOP Formed Through Privatization of a Government Operation* (April 15, 1996).

It took a lot of hard, groundbreaking work by a variety of advisors, bankers, lawyers, and employees to see the first transaction through. They are to be applauded for being pioneers in this area. Once the feasibility studies were completed and all were confident that USIS was a viable option, the employees selected a management team through the employees' agent, a commercial bank acting as financial trustee.

James Dobkin, in a special supplement for the BNA, explained how the transaction unfolded:<sup>101</sup>

OPM utilized the "public interest" exemption to federal requirements for competitive procurement and awarded a sole-source, contract for USIS to provide the investigative services formerly provided by federal employees. This assured the now corporation of a quantum of business to get it started. In a further effort to ease the transition and reduce the risk of a break or delay in service, the contract also allowed USIS to use government furnished property. This allowed USIS to remain in the same offices as when it was a division of OPM and use government-owned computers and other equipment. In exchange, USIS agreed to charge the government lower fees than what OPM now charges other agencies for background checks.

The greatest obstacle to the formation of USIS was Congress, which vehemently objected to putting arguably sensitive records in the hands of a private entity. A House subcommittee held hearings on the matter and several members of Congress tried to slow the transfer, questioning whether USIS would violate laws protecting privacy rights and whether local law enforcement agencies would turn over criminal records to a private company. Some even questioned whether privatization of this function would jeopardize national security. The potential security risks of transferring investigative functions from OPM to USIS were reduced by several means. As previously discussed, USIS handles only routine background investigations; it does not perform White House or Cabinet background checks. Also, DOD conducts its own through an in-house entity. To further alleviate congressional concerns, OPM will maintain a small staff to make policy determinations, ensure the quality of investigations, maintain the security of the records system, and administer the contract between OPM and USIS.

The OPM-USIS transfer also had to overcome arguments that it would cost the government too much money to privatize these functions. The General Accounting Office (GAO) estimated that it would cost \$5.7 million to effectuate the transfer from OPM to USIS. However, GAO conceded that the government would reap significant long-term budgetary savings as a result of the privatization. These savings have been estimated to be \$20 million to \$25 million over the next five years.<sup>102</sup>

Based on the USIS success story, several other governmental activities began to actively explore the ESOP option. The key to the transaction initially is being able to define revenues and expenditure streams with sufficient precision so as to allow for the creation of a business

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<sup>101</sup> See *Federal Privatization and Outsourcing of Information Technology Functions: A Practitioner's Perspective*, Fed. Cont. Rep. (BNA), Vol. 66, No. 19 (November 18, 1996).

<sup>102</sup> *Id.* As it turns out the savings have proven to be far in excess of these estimates.

plan. Activities that operate as enterprises with clearly defined revolving funds or reimbursable accounts are ideal candidates. Other activities with less clear revenue and expenditure streams may still be viable candidates depending upon how flexible the employees are willing to be and where new sources of revenue may be found.

### **C. A More Recent Example of ESOPs -- Mare Island Naval Shipyard and Charleston Naval Shipyard**

A more recent example of such a transaction involved the Environmental Detachments in Charleston, South Carolina, and Mare Island, California. At the direction of the 1993 Base Realignment and Closure Commission (BRAC), Mare Island Naval Shipyard and Charleston Naval Shipyard closed on April 1, 1996. As a result of the BRAC process, the Navy examined the concept of using shipyard workers to perform the environmental compliance and restoration services for these bases. The concept was approved, and during the closure process these workers received extensive training in many disciplines of the various environmental remediation fields. On April 2, 1996, the day after the closure of the two shipyards, the new Environmental Detachments (Detachments) began operations at each base. The Detachments were a federal government activity under the Naval Sea Systems Command (NAVSEA), Supervisor of Shipbuilding, Conversion and Repair Portsmouth, VA (SSPORTS).

The Detachments created successful operations under the uncertainty of BRAC and enabled continued federal employment of approximately 400 people. The Detachments emerged as two successful, business-like environmental engineering and remediation operations. Many of their federal government customers have come to respect the Detachments for their no-nonsense economical business operations. Moreover, the Detachments became the "provider of choice" because of their dual engineering and production capabilities, mobility, economy, quality of services provided, and ability to work closely with federal and state regulators. They provided accurate estimates and skilled people to correctly execute a wide variety of tasks. Few jobs exceeded their original budgets and customer satisfaction with the work was high. The Detachments were in existence for three and a half years and have provided full-spectrum, quick response capability to customers in approximately 22 states with total revenues of over \$145 million, on a cost-reimbursable bases.

The Navy intended the operations to be a temporary situation and the Detachments were scheduled to be eliminated on or before September 30, 1999. However, federal government customers had continuing needs for the unique capability of the Detachments. Among these requirements were emergent BRAC-like needs for facility outleasing at NAVSEA to economize operations at field activities. The Navy decided to dedicate resources to assist the Detachments in finding a way to exist outside the Navy. Pursuant to this decision, in August 1998 the Navy engaged Grant Thornton LLP to perform a feasibility study.<sup>103</sup> Grant Thornton was charged with (1) assessing whether it was feasible for the Detachments to be privatized, i.e. operate as an independent entity in the private sector in a manner that would meet the cost and technical objectives of current Federal Government clients; (2) determine what actions should be taken by the Detachments, SSSPORTS, and NAVSEA to enable successful and rapid transition to the private sector; and (3) determine if employee ownership

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<sup>103</sup> Portions of this article have been provided by Grant Thornton LLP, and the author would like to thank them for their help. In particular, the author would like to thank Diane Shute, Practice Leader of Grant Thornton's Outsourcing and Privatization Group.

of the new private company was viable through an Employee Stock Ownership Plan (ESOP).<sup>104</sup>

To help the Detachment choose which type of model they wanted to pursue, the Team was asked to examine a number of different business models that a private non-governmental entity, employing former Detachment employees, could form to provide services substantially similar to those the Detachments provides. Several different structures were examined, including:

- Private Stand Alone Employee Stock Ownership Plan Company
- Stand Alone Nonprofit Corporation
- Non-Appropriated Fund Instrumentality
- Partnership with an Existing Institution - Private Firm
- Partnership with an Existing Institution - Joint Venture
- Partnership with an Existing Institution - Nonprofit Charitable Organization
- Stand alone Newco with Management Contract with Successful Private Sector Contractor
- Affiliation with a Federally Funded Research and Development Corporation

1. *Types of ESOPs Examined by the Team*

a. Private Stand Alone ESOP Company

An ESOP is an employee benefit plan which makes the employees of a company owners of stock in that company. Several features make ESOPs unique as compared to other employee benefit plans. First, only an ESOP is required by law to invest primarily in the securities of the sponsoring employer. Second, an ESOP is unique among qualified employee benefit plans in its ability to borrow money. As a result, "leveraged ESOPs" may be used as a technique of corporate finance.

There are approximately 11,500 ESOPs in place in the U.S., covering 8.5 million employees (8% of the workforce).<sup>105</sup> These employees draw in excess of 3% of their total compensation from ESOP contributions.<sup>106</sup>

The growth of ESOP formation has been influenced by federal legislation. While the rapid increase in new ESOPs in the late 1980s subsided after Congress removed certain tax incentives in 1989, the overall number has remained steady with new plans replacing terminated ESOPs. The approximate chronology is as follows:

1974 - 200 ESOP companies 1981 - 1,500

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<sup>104</sup> New private company is referred to as "Newco" in this section.

<sup>105</sup> See *ESOP Statistics*, The ESOP Association, << <http://www.the-esop-empowner.org/pubs/stats.html> >> (visited April 3, 2001). For more detailed information please contact The ESOP Association at (202) 293-2971

<sup>106</sup> See *id.*

1984 - 2,500

1987 - 5,000 1990 - 10,000 1996 - 10,000 1997 - 10,000

2000 - 11,500.<sup>107</sup>

About 1,000 ESOPs -- 9% -- are in publicly-traded companies.<sup>108</sup> However, these companies employ more than 50% of the nation's 8.5 million employee owners.<sup>109</sup> An estimated 6,000 of the 11,500 companies have ESOPs that are large enough to be a major factor in the corporation's strategy and culture.<sup>110</sup> Approximately 2,500 ESOP companies are majority-owned by the ESOP.<sup>111</sup> Approximately 1,500 are 100% owned by the ESOP.<sup>112</sup> About 4% of ESOP companies are unionized.<sup>113</sup>

While ESOPs are found in all industries, more than a quarter of them are in the manufacturing sector.<sup>114</sup> At least three-quarters of ESOP companies are or were leveraged, meaning they used borrowed funds to acquire the employer securities held by the ESOP trustee.<sup>115</sup> Most companies have other retirement plans, such as defined benefit pension plans or 401(k) plans, to supplement their ESOP.<sup>116</sup> Of the 11,500 employee-owned companies nationwide, fewer than 5% were financially distressed when they established their ESOP.<sup>117</sup> Total assets owned by U.S. ESOPs amounted to \$500 billion at the end of 1999.<sup>118</sup> A total of \$20 billion in cash or stock was contributed to ESOPs in 1999. This equaled approximately 3.2% of total civilian employee compensation in that year.<sup>119</sup> Approximately 4% of the total value of U.S. corporate net worth in 1999, approximately \$500 billion in sponsor stock, was held in employee stock ownership plans.<sup>120</sup>

A company which wants to set up an ESOP creates a trust to which it makes annual contributions. These contributions are allocated to individual employee accounts within the trust. A number of different formulas may be used for allocation. The most common is allocation in proportion to compensation, but formulas allocating stock according to years of service, some combination of compensation and years of service, and equally, have all been used. Typically employees might join the plan and begin receiving allocations after completing one year of service with the company, where any year in which an employee works at least 1000 hours is counted as a year of service.

The shares of company stock and other plan assets allocated to employees' accounts must vest before employees are entitled to receive them. Vesting is a process whereby employees

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<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> *Id.*

<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

<sup>118</sup> *Id.*

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

become entitled to an increasing percentage of their accounts over time. The least liberal vesting schedule allowed by law is 20% per year until employees are fully vested after 7 years of service. Some companies, however, vest an employee's entire accounts right away.

When an ESOP employee who has at least ten years of participation in the ESOP reaches age 55, he or she must be given the option of diversifying his/her ESOP account up to 25% of the value. This option continues until age sixty, at which time the employee has a one-time option to diversify up to 50% of his/her account. This requirement is applicable to ESOP shares allocated to employee's accounts after December 31, 1986.

Employees receive the vested portion of their accounts at either termination, disability, death, or retirement. These distributions may be made in a lump sum or in installments over a period of years. If employees become disabled or die, they or their beneficiaries receive the vested portion of their ESOP accounts right away.

In a publicly-traded company employees may sell their distributed shares on the market. In a privately held firm, the company must give the employees a put option on the stock for 60 days after the distribution. If the employee chooses not to sell at that time, the company must offer another put option for a second sixty day period starting one year after the distribution date. After this period the company has no further obligation to repurchase the shares.

An ESOP company may make an "installment distribution," provided that it makes the payments in substantially equal amounts, and over a period to start within one year for a retirement distribution, within five years for a pre-retirement distribution, and not to exceed five years in duration in either case. The company must provide "adequate security" and pay interest to the ESOP participant on the unpaid balance of an installment distribution.

A company interested in establishing an ESOP has a wide range of options in tailoring a plan that is best suited to its particular needs and goals. A large, publicly traded company, for example, would handle the creation of its ESOP somewhat differently than would a smaller firm.

The first step in the process of establishing an ESOP is to develop an idea of the type of plan that will best serve the company's interests. Companies have created ESOPs as an employee retirement plan, for purposes of business continuity, financing, enhanced employee motivation or as a combination. Once you have a general picture of the kind of ESOP you want, a qualified consultant will work with you to design the specifics of the ESOP. The actual feasibility of an ESOP needs to be established. Custom-tailored answers to the many questions need to be answered. Who will participate in the plan? How will stock be allocated to participants? What vesting schedule will be adopted and how will distributions of ESOP accounts be handled? How will voting rights be handled?

In the case of a privately held company, the feasibility and design phase of the process is not usually complete until three additional points have been addressed. First, the firm's stock must be valued by an independent appraiser before shares are put into the ESOP. Initially, a careful estimate will be prepared for use as a working figure in the feasibility and design process. This initial appraisal will likely take several weeks or longer, since a significant amount of business data must be collected and analyzed. Only when the design process is completed and ready for implementation will a final and formal valuation report be prepared.

Second, the ESOP's effect on existing stockholders should be estimated. Stockholders will want to know how the ESOP will affect the value of their stock and the company's financial condition. Often an ESOP will cause a dilution of their equity interest in the corporation.

Finally, while not a requirement for establishing an ESOP, a plan for meeting the private closely held company's obligations to repurchase the stock of departing employees should be projected. This "repurchase obligation" arises from the fact that in privately held companies,

ESOP participants have a put option when leaving the company. The repurchase obligation and its growth over time may be affected by factors like the size of the annual ESOP contributions, the change in the value of shares between the dates of contribution and repurchase, the vesting and distribution provisions of the ESOP, employee turnover and, for shares contributed after December 31, 1986, the choices eligible employees make about their diversification option.

Companies may plan for and meet their ESOP repurchase obligation in a variety of ways, including making substantial cash contributions on an annual basis, and buying insurance to cover the plan's obligations. If the likely growth of repurchase obligation over time is projected at the outset, however, the company is in the best possible position to plan for it and design the ESOP accordingly.

When the process of analyzing and designing the ESOP is complete, the company will typically have an attorney prepare a formal plan document which will set forth the specific terms and features of the ESOP. An appraiser will then prepare a finished and formal evaluation report, based on data preferably no more than 60 days old at the date the ESOP is created.

The plan document should include language addressing the plan's purpose and operation, eligibility requirements, participation requirements, company contributions, investment of plan assets, account allocation formulas, vesting and forfeitures, voting rights and fiduciary responsibilities, distribution rules and put options, employee disclosures, and provisions for plan amendments. Depending on the particular circumstances of the establishment of the ESOP, it may be prudent to address any future contingencies in the plan document.

Other key decisions are who will serve as the ESOP's trustee and who will assume the functions of administering the ESOP? The stock (as well as any other assets) held by the ESOP must actually be held in the name of the trustee, who usually has fiduciary responsibility for the plan's assets. Increasingly, plan sponsors are turning to professional trustees, such as a bank or trust company, although companies sponsoring an ESOP can and do handle this role in-house. The job of ESOP administration is likewise a function which may be given to a professional administration firm or handled by the sponsor. The administrator is responsible for maintaining all the individual records of the plan in order to keep track of exactly who are the current participants in the plan, what percent is each participant vested, what is the content and value of each participant's account, etc.

In the case of leveraged ESOPs (an ESOP which used borrowed funds to acquire employer securities), arrangements must be made for securing the financing needed to complete the transaction. Banks, savings and loans, investment banking firms, mutual funds, and insurance companies in the business of lending money may all qualify as ESOP lenders. Lending institutions are becoming increasingly familiar with how ESOP loans are structured. If your local lending institution is unable to provide the necessary funding, a list of interested lenders is available from The ESOP Association.

The company must formally adopt the plan and trust documents which establish the ESOP and its attendant trust. Also, the company usually submits a copy of these documents to the Internal Revenue Service with an application for confirmation (called "determination") of the plan's tax-qualified status (Form 5500). The plan must be a qualified ESOP under sections 401 (a) and 4975 (e)(7) of the Internal Revenue Code in order to be eligible for the various tax benefits associated with ESOPs. It is not normally necessary, however, to wait for a letter of determination from the IRS to begin the plan. If there is nothing unusual in the plan's design, any required changes will almost certainly be small ones, which can be made after the plan has begun operation.

A company must adopt an ESOP by the end of its fiscal year to claim a deduction for its contribution for that year. Contributions and leveraging for a given year, however, may occur up until the company files its corporate tax return, including extensions.

Under this approach, an independent, private stand-alone company, referred to as "Newco," would perform environmental support services currently performed by government employees at the Detachments. Newco would be majority owned and controlled by employees from day one. Moreover, Newco would contract with current and new federal customers to provide environmental remediation services and would expand its market to provide services to state, local and commercial customers. All or a large part of the capital stock of Newco could be owned by an Employee Stock Ownership Trust (ESOT), established pursuant to an ESOP. An ESOT is a legal entity, separate from its sponsoring corporation, which separately holds assets and can sue or be sued as a separate entity.

The employees of Newco would have the status of private sector employees. Employees would no longer accrue benefits under the federal retirement programs (CSRS or FERS, as applicable). If financially feasible, Newco could establish a pension or 401(k) plan in addition to the ESOP. In many cases, the ESOP forms a part of an overall retirement package. A successful ESOP can offset, at least in part, the company's need to fund other programs to provide for the employees' retirement. For example, Newco could make cash contributions of at least five percent of gross payroll to its pension, or 401(k) plan, in addition to substantial stock contributions to an ESOP.

The Team concluded that an ESOP would be one of the more feasible implementations for the Detachments. However, the primary complication with this structure was that to institute and successfully initiate operation of Newco a customer base would have to be established in a timely manner. If there was insufficient workload available to Newco upon commencement to provide employment opportunities for a substantial number of current Detachment employees it would be extremely difficult for Newco to be viable and ownership interests by any party, including an ESOP, may not have any prospect of reasonable value.

#### b. Stand Alone Nonprofit Corporation

Under this approach, a private nonprofit corporation, referred to in this section as "Environmental Institute," would perform the environmental remediation services now performed by the Detachments.

The Environmental Institute would be a nonprofit corporation organized under state law. These laws generally require a nonprofit corporation to be organized for certain specific purposes as set forth in the statute, such as religious, charitable, educational, scientific, patriotic, political, or trade association purposes. In addition to complying with the nonprofit corporation laws of its jurisdiction, the Environmental Institute may qualify as a tax-exempt organization under the Internal Revenue Code (IRC) § 501(c)(3). Although scientific is one of the permitted organizational purposes, the IRC also requires that the organization not operate for the primary purpose of benefiting the private individuals, but for the benefit of the general public.

One general aspect of nonprofit status is that there be no "inurement" of financial benefits to the corporation's employees, directors, members, or anyone else. The nonprofit corporation's purpose must be to carry out its mission, not to make money. It may pay "reasonable" compensation to employees or directors, but any excess funds that it accumulates are to be used for its mission.

The anti-inurement requirements and other special rules for IRC §501(c)(3) organizations carry over into the employee benefit area. These organizations may not have 401(k) plans; however, they do offer tax-deferred annuities under IRC §403(b). Moreover, the standard for reasonable compensation would apply to the employees retirement programs and would be

compared to other IRC §501(c)(3) organizations. Very few, if any, nonprofit organizations offer retirement programs as attractive as the federal retirement program. In addition, nonprofit corporations cannot issue stock or pay dividends. This restricts their available options for financing themselves on a self-sustaining basis, but they can borrow money, secured by their receivables or other assets.

Given the difficulties with respect to the Environmental Institute's qualification for nonprofit corporate and charitable status from the IRS and the restrictions of the compensation and retirement programs, the Team concluded that adopting a nonprofit business structure would not be the best course of action. Although the Team realized that operating as a nonprofit charity conveys certain advantages in marketing its services, the Team did not believe it was possible to determine whether these potential marketing advantages would offset the disadvantages of the nonprofit structure.

c. Nonappropriated Fund Instrumentality (NAFI)

This alternative is similar to the nonprofit corporation discussed above. The principal difference is that a NAFI is established by a government agency in order to service a governmental purpose, rather than being established by private individual firms. However, under the NAFI the employees are not federal civil servants and do not participate in the federal retirement or other federal employee benefit system.

There are advantages and disadvantages to the quasi-governmental status of NAFIs. The advantages are that NAFIs can operate more flexibly than a government agency and they are not required to comply with all of the federal personnel rules and acquisition regulations. The most significant disadvantage is that a NAFI must keep an "arms-length" relationship with the federal customers much in the same manner as private industry.

For the existing Detachments to become a NAFI, either the Secretary of Defense or some other senior government official would have to incorporate it. It would not be able to enter into interagency agreements without a specific act of Congress. Absent such an act, there would be little difference between being a NAFI and being self-established IRC §501(c)(3), nonprofit organization.

d. Partnership with an Existing Institution

Each of the three alternatives described above assumed that the Detachment employees became employed as a stand-alone organization. The Detachments had many of the necessary elements for operating as a private company, but they did not have the complete framework necessary to operate as a stand-alone organization. The Detachments had no capacity for handling their own payroll, managing their own employee benefits program, filing tax returns, accounting for government contracts, or various other functions such as marketing and business development that private government contractors must perform. By forming a strategic partnership with an entity that already has these systems and procedures in place, the Detachments could avoid the problems associated with developing or contracting for these systems and procedures. Moreover, the Detachment's management would be occupied with keeping the workforce together to continue functioning as a cohesive unit and with assuring customers that the change to private sector status would not be harmful to the existing operations. The Team believed that it was better for management to focus on critical operational elements rather than being diverted into administrative issues that could be quickly resolved by affiliation with an existing entity.

Such partnering arrangements could include, but are not be limited to, the following:

e. Strategic Partnership Affiliation with a Private Firm

As opposed to becoming a private stand-alone company owned by the employees, the Detachments could have become employed by an existing environmental remediation services firm. They would have maximized their value and bargaining power by moving as a unit to a private firm and maintaining their identity as a division of the firm, rather than merely being hired as individual employees. The bargaining power achieved could have been used to obtain an ownership position in the combined enterprise or some other form of employee benefits or compensation, depending on what the Detachments desire. Moreover, the Team determined that this business structure could be implemented separately by each of the Detachments, so that the Vallejo Detachment could affiliate with one strategic partner while the Charleston Detachment could affiliate with another.

f. Strategic Partnership via Joint Venture

In this form of strategic partnership, the Team determined Newco could form a separate corporation that would enter into the formation of a third party business entity that was jointly owned by the strategic partner and Newco. Alternatively, the strategic partner could form a separate subsidiary that would enter into an agreement with the Detachments who were utilizing the bargaining power discussed above.

g. Strategic Partnership with an Existing Nonprofit Charitable Organization

Rather than operating as a stand-alone nonprofit charitable organization, as discussed above, the existing Detachment employees could have decided to operate in partnership with an existing nonprofit charitable organization. The partnership could take the form of current detachment employees becoming employees of the nonprofit organization, within the existing organizational and mission structure. On the other hand, the Detachment employees could maximize their value and bargaining power by moving as a unit to the nonprofit organization, and perhaps maintain their identity as a separate unit of the nonprofit organization. The bargaining power gained by the Detachment employees could be used to negotiate employment prospects, a degree of intra-organizational autonomy, or other potential benefits. Because of the nonprofit operating context of the partnership, the Team believed the Detachment employees would be unable to utilize this bargaining power to negotiate for an ownership position or incentive reward sharing based on business success. Such arrangements are not possible within the nonprofit business context.

The Team believed the Detachment's rationale for undertaking this type of partnership should be based on the nonprofit organization's ability to undertake business development activities. The business base should be sufficient to guarantee continuing employment for current Detachment employees for a reasonable period of time, such as five years. The compensation available to Detachment employees, under the existing compensation structure of the nonprofit organization, should be comparable to existing federal compensation. In addition, career paths and ability to transfer to other employment opportunities, within the nonprofit sector, could be examined and negotiated.

The Team suggested that the business rationale for this type of arrangement be based on the ability of the nonprofit to assist Newco and Detachment employees in mitigating the business risks associated with the transition to private sector operation by developing a sufficient business base immediately upon transition.

h. Stand-Alone Newco with Management Contract with Successful Private Sector Contractor

Another method of achieving an affiliation would be to enter into a management and/or marketing contract with a private firm, while remaining as a stand-alone entity. The services to be provided by the private firm would be carefully delineated in the contract. The payment for these services could be either a stated amount of cash, or perhaps an incentive method of

cash plus some percentage of Newco's revenues or profits. The Department of Defense sponsors "mentor" programs for 8(a) GTS firms that are very similar to management contracts. Conceivably, Newco may be able to access certain management services under this program.

- i. Affiliation with a Federally Funded Research and Development Corporation (FFRDC)

Another type of organization with which the former Detachment employees could have affiliated with is FFRDCs. FFRDCs are commonly understood to be long-term research and engineering "centers", operated by universities, not-for-profit private sector enterprises, or autonomous units of industrial parent corporations. FFRDCs are organized to assist their sponsors (federal agencies or offices) to capitalize on the strengths of the private sector to accomplish tasks that, while integral to their sponsors' missions and operations, nonetheless are not "inherently governmental functions". Thus, FFRDCs perform specific and limited duties as set forth in their governing contracts and mission statements, rather than acting under any general legal authority to perform a governmental function. Given their contractual nature, FFRDCs are by definition, neither a government entity, federal agency, nor an instrumentality of the United States. Although they tend to vary widely in terms of size, mission and technical/analytic focus, FFRDCs are commonly classified into three major categories: research/R&D laboratories, studies and analyses centers and systems engineering centers.

For various reasons including increased U.S. Congressional scrutiny, control and stringent restrictions the Team did not believe that it was realistic for the Detachments to consider becoming an FFRDC.

## 2. *Feasibility Assessment*

The Team was not able to recommend a single proper business model for Newco that would maximize its ability to compete in the private sector. However, the analysis undertaken by the Team indicated that both stand-alone and partnership strategies with for-profit and nonprofit entities had the most potential for feasible implementation. The Team recommended that Newco enter into a partnership with an existing entity of the appropriate structure in order to facilitate the transition to the private sector and minimize employment and retirement benefit risk to Detachment employees.

A partnership, the Team determined, would enhance Newco's ability to meet transitional challenges and contained various advantages. There were multiple advantages to implementing a strategic partnership. The primary transitional challenge was the ability to undertake adequate business development activities prior to October 1, 1999 that would result in the contracting of a minimum amount of services annually over the next four years needed to support the Detachment Employees. A partnership was thought to increase the probability of a successful transition given the short time frame for transition and the magnitude of the business development and operational challenges that must be overcome. This also provided employment opportunities for all Detachment employees that desired employment with Newco. The Team also noted that Newco should expect and would find substantial competition from existing private sector service providers in its attempts to penetrate the relatively mature market for remediation services. The second challenge found was the reduction of business risk associated with both the initial transition to a private sector operation and the future ongoing operation of Newco. Third, the business risk was reduced by the partner's ability and willingness to provide the transitional working capital funding needed by Newco to sustain operations from October 1, 1999, until the receipt of payments from customers.

The Team's analysis concluded that the business and operational conditions at the Detachments resemble those that exist in successful private sector government technical

service firms. The Detachments, with a few exceptions, had operated on self-sustaining funds generated from successful performance of environmental remediation engineering and construction services for a wide range of federal government customers. The Detachments had demonstrated the ability to operate reliably in the federal environment, and had taken "in-house" certain support functions.

The reduction of employment risk was based on the ability of the potential partner to do the following:

- 1) Successfully undertake marketing and business development efforts on behalf of Newco in its first years of operation;
- 2) Provide operational support and assistance to Newco;
- 3) Assist in obtaining adequate working capital;
- 4) Develop career paths and employment opportunities for Newco employees who desire to transfer from the Detachments; and
- 5) Provide employment opportunities if these contracts do not continue or if new customers cannot be found in a timely manner.

The criterion for partnership selection was the strategic partner's current efforts and ability to pursue other business development efforts in the environmental remediation services market, primarily in the two geographical areas where prospective Newco employees were residing.

The business risk associated with the ownership interest and employment of Newco employees was assessed as significantly higher in the stand-alone implementation option than in the strategic partnership approach. Based on a number of factors, the strategic partnership approach offered the best risk/reward profile. The Team assessed that the rewards of this profile could be enhanced by entering into a strategic partnership with a company that already had a substantial employee ownership program in place, or was willing to enter into such arrangement in the future, in conjunction with implementation of the strategic partnership.

The analysis undertaken by the Team indicated that both stand-alone and partnership strategies with for-profit and nonprofit entities had potential for feasible implementation. The Team did recommend that Newco enter into a partnership with an existing business entity of the appropriate structure, in order to facilitate the transition to the private sector and minimize employment and retirement benefit risk to Detachment Employees. A partnership would enhance Newco's ability to meet the potential transition challenges.

### 3. *Feasibility Study Conclusions*

The Team concluded that it was viable for the Detachments to transition from a government operation to private sector operations, under the following conditions:

- By early December 1998, NAVSEA must concur on the continuation of a federal environmental remediation requirement accumulation point at SSPORTS or another NAVSEA element.
- By January 1999, NAVSEA must concur on the development of a contract vehicle that will allow the retirement accumulation point to contract with Newco on behalf of current and future Federal remediation customers.
- By July 1999, a contract award for environmental remediation services must be made to Newco.

- Beginning Fiscal Year 2000, Newco will begin performance on this contract.
- The Detachments' operational equipment, currently owned by the Navy and other DOD commands, would be rented or leased as part of this contract to allow for use on other nonfederal government projects.
- The Detachments' equipment and facilities, owned by the city of Vallejo or State of South Carolina, would be leased or provided under the facilities rental contract.
- Newco should either commence a partnership arrangement with an appropriate private sector entity either jointly or individually, or recruitment of executive management with private sector experience in the government technical services industry to provide transition assistance to current Detachment management for stand-alone operations.

In addition, the Team suggested the next action, following the feasibility study, should be to develop a business plan. The Team recommended formulating detailed transition initiatives within the business plan that Newco would employ to mitigate the business risk areas identified above.

As a next step in the process, NAVSEA wrote an RFP for the environmental remediation efforts at both the Detachments and the employees of the Detachments who were planning on forming strategic partnerships to bid on the work at the Detachments. It was necessary for NAVSEA to build a firewall to enable a procurement to be conducted without the Detachments having an unfair advantage over the private-sector competition. In addition, the firewall needed to be built to ensure that the RFP was not written to cater specifically to the Detachments to ensure they win or written specifically against the Detachments to ensure they lose.

The RFP was written to replicate the capabilities of the Detachments once they were

This procurement was distinguishable from prior Navy contracts vehicles such as Remedial Action Contracts (RAC) and Comprehensive Long-term Environmental Action Navy (CLEAN) in several ways. The IDIQ contract provided for:

- The ability to obtain the full spectrum of engineering and field services involved in an environmental remediation request, from program planning and management to technical services, remediation action and abatement, covering multiple media within one request.
- The ability to secure BRAC and outleasing compliance and support services.
- Significant reduction in procurement process, approvals and timeframe through the transfer of funds to a contract accumulation point within the Department of the Navy.
- Highly mobile business units operating as needed in geographically dispersed and remote areas.
- Exceptionally prompt service and quick reaction capabilities.

The RFP was designed to ensure that Federal Government customers continue to have access to a wide range of high quality, cost efficient, timely and quick reaction capability environmental engineering, remediation, BRAC, OSH (Occupational Safety and Health) Requirements and outleasing support services. SSPORTS acted as the task order accumulation point for the procurement, allowing federal government customers to obtain the full spectrum of services. The major advantage of this approach was that federal government customers could obtain services through inter-agency agreements and task order work statements, rather than the more cumbersome process associated with individual contracts.

Contractors were asked to provide all the necessary personnel, equipment, technology, materials and facilities to respond to multiple requests for emergent short term tasks including, but not limited to:

- Asbestos surveys, containment and abatement;
- Base Realignment and Closure (BRAC) and outleasing support;
- Building closure/site assessment safety and health inspections.
- Building stabilization, modification and destruction;
- Database management and information systems;
- Draft findings of suitability to lease (FOSL) and transfer (FOST);
- Dredging;
- Ecological risk assessments;
- Environmental baseline surveys;
- Environmental compliance projects;
- Environmental laboratory work;
- Excavation/soil separation, treatment and restoration;
- Facility/Equipment Inspection;
- General Radiological Material (G-RAM) assessments, surveys, sample analysis and remediation;
- Hazardous waste management;
- Health and Safety Planning for remediation operations;
- Heavy equipment operation;
- Installation restoration work;
- Lead surveys, abatement and reports;
- Management of ozone depleting substances;
- Operation, maintenance and lay away of large mechanical systems;
- Polychlorinated Biphenyl (PCB) survey and abatement;
- Site Specific Health and Safety Plans;
- Underground storage tank (UST) and above-ground storage tank (AST) work; and
- Unexploded ordnance (UXO).

Within the solicitation, NAVSEA developed a hypothetical sample task. The sample task was considered a critical element of the procurement and was a means to evaluate an

offeror's ability to understand, plan and execute the unique requirements of a complex but representative task. Offerors were required to provide the following: (i) The planning process to be used in preparation to accomplish the work of the sample task; (ii) Critical cost and schedule risks; (iii) Organization and management of the task team; and (iv) A work plan and implementation schedule that achieved the stated objectives.

By using performance based task orders for the IDIQ procurement NAVSEA was able to write the solicitation to support environmental engineering, remediation and abatement, outleasing and occupational safety and health requirements for the Navy and other Federal Government agencies.

#### 4. *Business Case for Transition to Private Sector Operation*

Grant Thornton LLP was asked to assist the Detachments in the transition to the private sector. Grant Thornton assisted in simultaneously performing a business case analysis and selecting a strategic partner for the Detachments. Within the business case analysis the Partnering Team (consisting of Grant Thornton employees separated from the NAVSEA Team and employees of ESOP Advisors) provided a strategic plan for the Detachments. Pursuant to recommendations in the feasibility study, the business plan was comprised of business objectives and a business strategy that included strategic partnerships and alliances.

##### a. Strategic Plan

The Partnering Team assessed that the business objectives of the Detachments were to become a profitable private sector competitor in the maturing environmental remediation services industry, and to extend their profitability in future years. In addition, the Detachments needed to restructure operations to respond to new market opportunities that may emerge. In order to achieve its business objectives the Detachments decided to utilize the strategy of initially entering the private sector environmental remediation industry in a partnership with a business entity. The Detachments concluded that a partnership strategy, while not offering the absolute highest level of gain sharing potential available in a stand-alone context, would mitigate the various business risk areas including:

- Difficulty completing the initial operational transition to private sector operation while continuing to serve the current customer base.
- Inappropriate level of business development during the transition which may not allow for the employment of all current Detachment personnel.
- Potential not to achieve the first-year profitability objective.
- Detachments, on stand-alone bases, would not be able to put in place the necessary contract vehicles required to continue to serve their satisfied federal customers in their first year of operation.
- Detachments, on stand-alone bases, would not have the financial and business resources to make attractive and competitive employment offers to existing personnel in today's tight labor markets.

##### b. Market Definition & Segmentation

The Partnering Team recommended that the Detachments build upon the marketing analysis developed in the feasibility study and develop individual marketing plans for each of the Detachments based on their existing business service areas. The business service areas for Vallejo would be environmental remediation services and submarine/ship repair services, while the business service areas for Charleston would be strictly environmental oriented such

as remediation, engineering design, construction and reporting, as well as environmental oversight and management of ship scrapping operations. The Partnering Team then made suggestions on which market segments the Detachments' marketing efforts should target.

#### c. Market Strategy

The Partnering Team's focus of the market strategy was to maximize the potential entry of the Detachments into the marketplace. The market strategy indicated that the Detachments should focus on the following areas:

- Playing a role in a niche company;
- Using strategic alliances to develop business;
- Focusing on their core competencies; and
- Expanding capabilities through utilization of innovative remediation technologies.

The Partnering Team believed the Detachments' marketing plan should develop and implement the following priorities: (1) stabilize the current base of business with all customers and current lines of services offered; (2) expand services, business lines and markets; and (3) penetrate commercial markets with existing business lines.

Another recommendation for the market strategy was to broaden the customer base by building strategic alliances. A new market entry without the formation of strategic alliances would be very difficult. Focusing on the core competencies of the Detachments can alleviate this difficulty. By focusing on the Detachments' core competencies in GIS radiological surveying, data management and remedial construction experience, the Detachments could develop an integrated approach to provide much needed services.

#### d. Operational Plan

With the selection of a strategic partner in the private sector the Partnering Team concluded that a seamless transition would successfully occur. The strategic partner would provide for a transition plan to allow for service to customers prior to the elimination date of the Detachments. During the first year of private sector operations Newco would utilize the knowledge base and operational infrastructure employed by its strategic partner to improve its current operations. Additionally, Newco would have to plan to improve their direct labor utilization rate to allow more revenue to be produced from the same cost structure that was primarily personnel based. The existing accounting/financial management systems that were based on the federal operating structure had to be revised to meet the demands of private sector operations.

#### e. Organization & Management

All of the potential partners of the Detachments had written proposals under the operating assumption that the Detachments would continue to operate as relatively autonomous business units within the partner's organization. Therefore, it was very likely that the operational and management structure currently found in the Detachments would remain unchanged.

#### f. Financial Plan

The Partnering Team concluded, after making a number of assumptions that Newco could become financially viable stand-alone company. These assumptions included a significant book of business by October 1, 1999. Primarily based on this challenge, the Partnering Team recommended the Detachments enter into a partnership with an existing business

entity of the appropriate structure in order to facilitate the transition into the private sector and to increase the probability of success given the short time frame for transition.

#### g. Private Sector View

Proposals from potential strategic partners in the private industry indicate that the Detachments represent a viable business addition. The proposals presented an organizational structure of the Detachments that would allow them to operate as a separate profit center or business entity within the strategic partner's company. The receipt of such proposals represented that the private sector believed that there was a business case for the Detachments and confirmed the Partnering Team's conclusions in the feasibility study and the business case.

#### h. Assessment of the Business Case

The Detachments, as the Partnering Team concluded, were well-positioned and prepared to transition to successful private sector operations. This undertaking accomplished the dual goals of outplacement and outsourcing, with the added advantage of keeping business units and personnel intact. Additionally, in the assessment the Partnering Team prepared a five-year pro forma financial projection for Newco. Through the research, projections, and market analysis, the Partnering Team determined there was a clear and convincing business case for profitable operation of the Detachments in the private sector.

### 5. *The Strategic Partner Selection Process*

As a follow-on effort to the feasibility study and as a simultaneous project to the business case analysis, the Partnering Team assisted in the transition of the Detachments to private sector operations. To continue in their assistance to NAVSEA the Partnering Team supported the strategic partner selection process. In this role the partnering team focused on the following tasks:

- Identifying interested organizations to serve as strategic partners for the Detachments.
- Developing and proposing an evaluation plan for the selection of one or more strategic partners.
- Assisting in the evaluation of proposals from potential strategic partners and providing recommendations to the Detachment employees regarding teaming with a partner or operating as a stand alone employee stock ownership plan.

The Partnering Team, in the first phase of the strategic partner selection process, developed a structure with which to work. The Partnering Team then developed a technical approach, an evaluation plan for the strategic partner selection process, and a business development plan.

#### a. Identifying Interested Organizations

The Partnering Team began the partnership search by identifying strategic partners. Once identified, potential strategic partners were contacted and invited to attend "Industry Days." Two "Industry Days" were held at both Detachments in December 1999. Thirty representatives from 18 different organizations attended at least one of the "Industry Days." At the "Industry Days," potential partners were briefed on the acquisition opportunities and given an opportunity to ask questions. In addition, participants were presented with the following documents: (i) the privatization feasibility study for the Detachments; (ii) the federal government's plan for strategic partnership to transition the Detachment Employees into the private sector; and (iii) the background on the Detachments and their operations. In addition, potential partners were able to conduct due diligence inspections at the Detachment

operations. Eleven potential strategic partners submitted indications of interest in partnering with the Detachments.

b. Evaluation Plan

In addition to assisting in the identification of interested organizations, the Partnering Team assisted in the formulation of an evaluation plan for the potential strategic partners.

The strategic partner selection criteria were developed on the basis of the objectives laid out by NAVSEA and recommended in the feasibility study. Discussions were held at each Detachment to receive the input of members of the Employee Liaison Committees in the development of the final strategic partner selection criteria. The final selection criteria were as follows:

- *Marketing and Business Development* - Potential strategic partners were required to propose the specific and detailed marketing approach and business development plan they would implement. Additionally, potential partners were asked to demonstrate their ability to undertake marketing and business development prior to the privatization to ensure a full workload by Newco beginning October 1, 1999.
- *Compensation and Employee Benefits* - Potential partners were requested to supply information regarding: (i) methods which they intended to make private sector employment offers to current Detachment personnel; (ii) employee benefit plans, including retirement plans; (iii) pay ranges for broad labor categories; and (iv) ability and willingness to offer current levels of compensation for Detachment employees that transitioned to Newco.
- *Gain Sharing* - Potential partners were requested to describe any "gain sharing" employee benefit or compensation programs that they would institute in Newco for the benefit of Newco employees. These programs could include elements such as bonuses, profit sharing, promotion opportunities, and stock option programs.
- *Transition Assistance* - Potential partners were requested to explain their ability to assist Detachment Employees in the transition from federal operations to the private sector.
- *Track Record* - Potential partners were requested to describe their capability experience and track record of success in similar circumstances of transitioning employees.
- *Operational Support* - Potential partners were requested to describe how they would provide operational support to Newco in the transition period and the first year of operation. Areas of operational support include: (i) cost accounting; (ii) personnel and employee benefit programs and systems; (iii) financial management and accounting systems; (iv) safety and occupational health systems and standards; and (v) quality improvement and assurance programs.
- *General Business Profile* - Potential partners were requested to explain how their business would merge with the Detachments. Potential partners were asked to demonstrate their financial capability to fulfill their proposal and assist the Detachments in successfully achieving and maintaining profitable private sector operations. In addition, potential partners were asked to address their interest in and the means by which they would empower Newco to achieve their business case including issues of management and control.

c. Assistance in the Evaluation of Proposals

All interested parties in forming a strategic partnership were required to submit partnership proposals to the Partnering Team. The Partnering Team and members of the Employee Liaison Committee reviewed proposals and determined the initial selection of the top partners for each Detachment. The initial selection was based on the Partnering Team's evaluation of the formal proposals and input from each of the Employee Liaison Committees.

The top finalists for each Detachment were given an opportunity for oral discussions and to answer questions written by the Employee Liaison Committee. In addition, these finalists were given an opportunity to modify their initial proposal and to submit their final proposal to the Partnering Team.

The Partnering Team performed an evaluation of the final proposals using the same criteria used for evaluation of the initial proposals. Collaboratively, the Employee Liaison Committees and the Partnering Team made a final selection of a strategic partner for each Detachment. The strategic partner chosen for the Vallejo Detachment was Roy F. Weston, Inc. and the strategic partner chosen for the Charleston Detachment was the South Carolina Research Authority.

#### d. Implementation

The Partnering Team was contacted by NAVSEA to provide transition assistance between the three interested entities: NAVSEA; the Detachment employees; and the selected strategic partners. (Roy F. Weston, Inc. (RFW) for the Vallejo Detachment and the South Carolina Research Authority (SCRA) for the Charleston Detachment.) To assist in this transition the Partnering Team conducted meetings to resolve all issues relating to the implementation.

RFW and SCRA, indicated that certain issues needed to be resolved prior to the transition. One of these issues included training of Detachment Employees in areas such as health and safety, project-management and advanced computer skills. In addition, the strategic partners identified their desire to hire or contract with certain Detachment personnel or contractors supporting the Detachments.

The NAVSEA identified issues such as the need to strictly comply with conflict of interest issues and ethics regulations in the hiring process and the need for continuing internal communications with NAVFAC and other SSPORTS customers. This communication concerned the continuing ability of and the requirement for the Detachments to continue to service existing remediation workload during the transition period.

The Partnering Team also entered into discussions with the Director of each Detachment where additional transition issues were identified. Issues identified by the Charleston Detachments were:

- Relationship between the SCRA and the Detachments with respect to data required by SCRA for business development efforts.
- Development and facilitation of training requirements for Detachment employees.
- Facilitation of hiring of current Detachment personnel specialist by SCRA on a part-time basis to assist in the hiring process.
- Facilitation of communication with NAVSEA concerning data calls on the Detachments and Federal employment issues for the permanent employees of the Detachments.

Discussions with the Vallejo Detachment led to the following issues being identified:

- Conflict of interest waiver letters being prepared by NAVSEA.

- Facilitation of equipment leasing.
- Transition training.
- Employment offers and communication of offers to Detachment employees.
- Post transition conflicts of interest.
- Internal restrictions on use of certain contracting vehicles for post transition workload.

The Partnering Team held many meetings with the Detachment Employee representatives, NAVSEA, and the selected strategic partners to assure all concerns were adequately addressed. The Partnering Team assisted by formulating a task plan with the Detachment management. This plan was then discussed with all other parties to ensure all issues were addressed.

In addition, the Partnering Team met with other parties to assist in addressing various concerns. Meetings were held with: (i) real estate leasing representatives of the Detachments, (ii) the Chamber of Commerce of Vallejo to address questions that the local business community had about the transition process, and (iii) the NAVSEA representative tasked with internal NAVSEA transition issues. Moreover, the Partnering Team facilitated the development of training requirements for each of the Detachments and the discussions between the strategic partners and the leasing representatives.

To assist the Detachment employees in interpreting employment offers and the benefits associated with the offers, the Partnering Team discussed and coordinated with all parties specific employment issues. These issues included form, timing, and content of employment offers to rank and file employees and managers. In addition, benefits were discussed including 401(k) retirement plans, health plans and cafeteria plans. To assist in the dissemination of information the strategic partner offered employees responsible for personnel part-time employment, these employees disseminated benefit information to Detachment personnel. This was done at times and locations not connected with Detachment operations. This method of part time employment with the strategic partner accomplished the elements of the scope of work, which required the development and implementation of transition procedures that would allow certain Detachment employees to transition to private sector employment prior to the separation date. The Partnering Team also facilitated the development and implementation of marketing and business development efforts that were identified in each of their winning strategic partnership proposals.

Lastly, the Partnering Team focused on coordination of potential public information efforts by the partners with NAVSEA and the Detachments. The Partnering Team provided assistance in interpreting and explaining, the similarities and differences of the private sector employment offers and benefits to governmental plans which Detachment personnel were accustomed to. Additionally, in this effort, the Partnering Team facilitated aspects of the hiring process where offers were made to almost all of the Detachment personnel.

## 6. *Conclusion*

Environmental Detachments at Vallejo, California, and Charleston, South Carolina, Naval Shipyards were established on April 2, 1996. The decision to transition almost 400 federal government employees from shipyard work to environmental compliance and restoration was a result of decisions made by the Base Realignment and Closure (BRAC) Commission. The Detachments were given a three and one-half window of opportunity to operate which enabled the continued employment of almost 400 civilians who otherwise would have been terminated under BRAC guidelines.

Over the next two and a half years, the Detachments emerged as two successful, business-like environmental engineering and remediation operations. They expanded their capabilities and customers and provided a full spectrum of environmental services. In anticipation of being eliminated on September 30, 1999, the Detachments explored a variety of ways to continue to operate outside of the Navy. The two Detachments chose to continue to operate with a private entity as a strategic partner. The Charleston, South Carolina Detachment became a strategic partner with the not-for-profit organization, the South Carolina Research Authority. The Vallejo, California Detachment became the strategic partner with a for-profit company, Roy F. Weston, Inc.

In October of 1999, the NAVSEA RFP to supply environmental remediation services was awarded. In Vallejo, California, Roy F. Weston, partnered with the Vallejo Detachment employees, was awarded the NAVSEA IDIQ contract. In Charleston, South Carolina, the South Carolina Research Authority was not awarded the NAVSEA IDIQ contract. However, in both cases the Detachment employees were strategically partnered with their respective entities and are presently assisting in the completion of environmental remediation projects.

## II. The Transitional Benefit Corporation Model<sup>121</sup>

The ESOP model has many appealing features to it, but it also has several limitations. First, it does not offer immediate savings to the federal government as in the case of an A-76 competition. Second, it does not afford the employees an opportunity to preserve their retirement or health benefits. Third, while it does preserve critical capabilities by placing them into viable businesses in the private sector, it does not afford the government with much flexibility in the event that it needs to draw on them quickly in case of a national emergency. To address these concerns, we have developed a new business model: the Transitional Benefit Corporation.<sup>122</sup>

### A. Description

The Transitional Benefit Corporation (“TBC”) is a vehicle to promote the transfer of designated, generally underutilized, government assets, such as real estate, equipment, and intellectual property, to the private sector. The TBC also enables associated government employees similarly redeployed to retain and accrue their public benefits. The TBC Method delineates a legal and business framework for effecting such transition using a nonprofit umbrella structure. It provides a structured methodology to analyze selected government operations with a view towards enhancing efficiency by reducing costs; redistributing workload; and maximizing asset utilization.

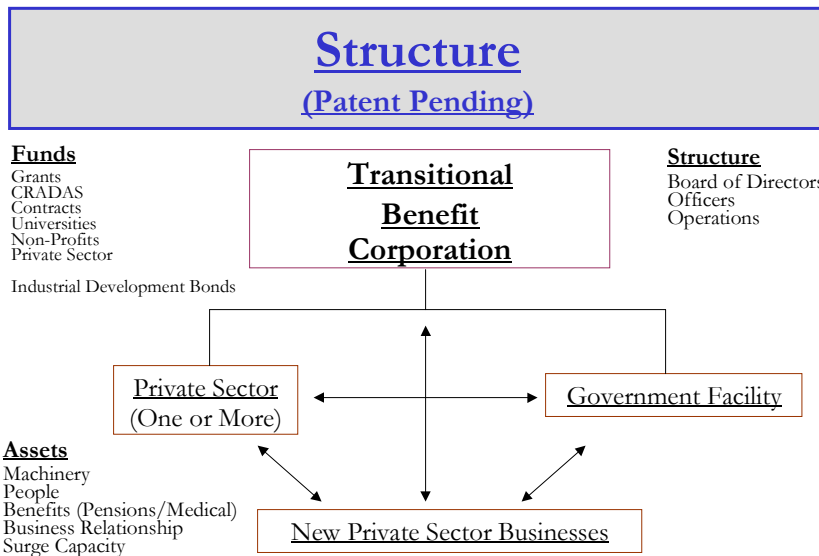
Pursuant to the TBC Method, an umbrella organization is created that facilitates the smooth transition of public sector assets and personnel to the private sector by attracting financing; incubating new business units and creating spin-offs; commercializing government-owned

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<sup>121</sup> The Transitional Benefit Corporation is a proprietary business concept that is the subject of a pending patent application before the United States Patent and Trademark Office. The author and Roger Feldman are the inventors of the TBC concept.

<sup>122</sup> Portions of this section on the TBC are derived from a report the author did for the National Environmental Technology Laboratory and United States Department of Energy. The author would like to especially acknowledge Walter Howes, Director of the Office of Privatization and Contract Reform at the Energy Department.

intellectual property. The TBC Method is implemented through the contractual interplay under the TBC for the continued performance of the installation's functions between any existing government installation transferring functions and related personnel, one or more public sector units, and one or more new business units ("NBUs"), and possibly one or more nonprofit corporations organized under the auspices of state or local government, consistent with the corporations laws of the particular state. Under the TBC Method, the TBC enters into contracts directly with the existing government installations and NBUs to achieve the benefits described below. Note that all of these units are necessary in every case to achieve the benefits set forth in Section II, below.



## B. Unique Benefits of the TBC

The TBC Method is designed to be a preferred alternative to outsourcing, managed competition (e.g. the A-76 program), privatization, or base closures because of three unique aspects. Because of its uniqueness, the TBC is a patent pending methodology.

### 1. Economic Development And Savings

First, the TBC Method provides for potential economic development and savings to the government. The TBC Method furnishes growth opportunities in the communities where the generally under-utilized government assets now reside. Government facilities that are potential candidates for closure (e.g. Department of Defense or Department of Energy installation), as well as activities such as laboratories or other active operations that have viable commercial markets, are ideally suited for oversight by a TBC. The TBC provides for savings to the government because while the government installation no longer must maintain the assets and the personnel; it continues to have access to them on a contractual basis, thus providing the surge capability mentioned below. The TBC Method also creates potential for economic growth by focusing on the government's mission while utilizing the former government employees ("Transitional Benefit Employees" or "TBE") to grow new business opportunities.

Under the TBC Method, the government will realize economic savings not only in nonrecurring costs but also recurring costs. It is estimated that a typical TBC transaction can be accomplished within six months, with savings being realized shortly thereafter. By contrast, under the A-76 process, the transaction may take up to four years, with savings not recognized until the end of the fifth year. Since the time is compressed to conduct a TBC transaction, the costs are necessarily reduced. In contrast, the A-76 process places significant economic costs on the government.<sup>123</sup>

## 2. *Surge Capability*

Second, the TBC Method provides the government with the ability to "reach back" on a temporary basis through the TBC and associated contractual arrangements into the nonprofit, private sector, and/or the NBUs to use the assets and TBEs in the event of an emergency or surge in workload. In contrast, under an A-76, the government may have to reduce its workforce by as much as a third to meet its Most Efficient Organization ("MEO") cost reduction goals. By reducing its workforce under the MEO, the government sacrifices mission flexibility in the event of a national security emergency or spike in workload. Under the TBC Method, the NBUs will likely not only have the full staffing of existing skilled employees capable of performing the required work, these NBUs have the flexibility to rapidly expand its workforce free from the delays caused by government hiring policies and procedures.

## 3. *Soft Landing For Former Government Employees*

Third, the TBC provides for a "soft landing" for former government employees. Under the TBC, these TBE's are not only guaranteed a job (most likely for one year) in the private sector organization under the auspices of the TBC, but are also able to retain and continue to accrue government pension, health, and insurance benefits during such period of private employment. Indeed, these benefits are paid for by the private sector – at a reduction in cost to the government. This agreement is attractive to all of the affected parties: the TBE retains their job and benefits; the government does not need to undergo a reduction in force ("RIF") and thereby avoids termination costs and internal disruptions due to workforce restructuring; and the private sector entity gains well-trained, knowledgeable, and valuable employees.

### **C. Implementation of the TBC Model**

The TBC is implemented typically in one of two ways. The first way is for the government to initiate the effort. The second way is for a private sector or nonprofit entity to submit an unsolicited proposal to the government.

#### 1. *Performance Work Statement and Business Plan*

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<sup>123</sup> In the recent study of the A-76 process, General Accounting Office reported that the average cost per position under study was \$2,000-6,000. See United States General Accounting Office, *Report to the Chairman, Subcommittee on Military Readiness, Committee on Armed Services, House of Representatives: DOD Competitive Sourcing; Questions About Goals, Pace, and Risks of Key Reform Initiative*, GAO/NSIAD-99-46, at 10 (February 1999).

In either event, the government activity or activities that are the focus of attention must be examined on a profit and loss basis. This is done in mostly the same way that a business is examined, using balance sheet and income statement analysis. If the activity is not susceptible of being examined on this basis, it is doubtful that it will be a viable candidate for the TBC model. If the activity does lend itself to a profit and loss examination where revenues and expenditures can be clearly identified on a fully allocated basis, then it may be a viable candidate for the TBC -- provided that basic things occur.

First, the government must have a clear enough idea about what its future workload needs are in order to permit drafting of a performance work statement ("PWS"). The PWS will be the basis for a contract between the government and the activity once the activity is spun out into either the nonprofit entity or the private sector. Importantly, unlike the PWS that is developed for the purposes of a competition conducted under the auspices of OMB Circular A-76, the PWS for a transaction using the TBC model will include provisions to address "surges" or spikes in workload. This way the government will have the contractual right to "reachback" and use the people and assets of the former government people until the contingency that gave rise to the surge or spike dissipates. Second, the activity must develop an overall business plan that not only includes the PWS with the government for whatever period of time can be negotiated, but also includes additional federal, state, and local government work, as well as work in the commercial sector.

## 2. *Conflict of Interest Representative*

It is important to keep in mind at the outset that there are certain important conflict of interest rules that must be followed. These rules essentially prohibit the government employees who work in the activity or activities from participating directly in any negotiations with the government regarding the terms of any future work that they may perform for the government under the PWS once they are spun off into either the nonprofit entity or the private sector. To overcome this impediment, the employees who will be spun off will designate a representative or fiduciary that will act on their behalf to enter into negotiations with the government.

## 3. *TBE Fiduciary*

One of the key features of the TBC is that it preserves the retirement, medical, and life insurance benefits for those former federal employees (Transitional Benefit Employees or "TBEs") who elect to retain and continue to accrue their benefits rather than receiving benefits from their new employer. The nonprofit organization in this business model is considered the Transitional Benefit Corporation or "TBC," and one of its main missions is to act as a fiduciary for the TBEs especially in dealing with the Office of Personnel Management ("OPM"). The TBC can serve as the representative of the employees for conflict of interest purposes as well as the fiduciary for the TBEs with respect OPM.

## 4. *TBC Accounts*

For federal government plans, the TBC Method provides for an account to be preferably established with the United States Government, possibly through the United States Office of Personnel Management or United States Department of Treasury, for maintaining benefits of transitioned personnel. A similar arrangement can be established for units of state or local government employing the TBC Model. The account would be fully funded, either directly or indirectly, by the new employer. The new employer is responsible for contributions to the account to maintain the benefits. To the extent permissible by law, the new employer may make contributions directly to the account. Alternatively, and in the event direct contributions may not be permissible, the contributions may be made in the form of an offset against monies due by the government for services rendered by the new employer. In such case, the government will internally apply those offset amounts to the account. Again, the government faces no adverse economic impact in allowing the transferred employee to continue to

participate in the plan and, in so doing, substantially reduces the likelihood of employee opposition to transition.

#### 5. *TBC as Fund Raiser*

The TBC will not only act as the fiduciary for the TBEs while they remain within the overall TBC structure, but it will also serve as a vehicle for raising funds in a way that neither the private sector nor the government can do. The TBC can enter into grants from federal, state, and local governments as well as private sector foundations. It can obtain Cooperative Research and Development Agreements. It can also issue its own debt in the form of Industrial Development Bonds or private activity bonds. Finally, it can enter into arrangements with other nonprofit organizations and universities.

Through these means, the TBC will be in a position to provide working and investment capital to be used within the overall structure of the TBC model. The funds will be used for two primary purposes. First, the TBEs will have developed a business plan and will need working capital to market and sell into the business areas outside of the PWS with their former agency. Second, some of the TBEs may decide to create new businesses on their own and will need funding, much in the way that new businesses seek out venture capital financing. These new business entities may take the form of Employee Stock Ownership Plan (“ESOP”) companies that are owned totally or partially by the TBEs who obtain an equity interest in the company in addition to retention of their benefits. It is also possible for the government and the private sector participants under the TBC model to secure equity positions in the new companies.

#### 6. *Structure of the TBC*

The TBC under the model is a nonprofit organization authorized to do business in the state or states where the PWS will be performed and where the TBEs will execute their business plan for growth beyond the PWS. Under state law, the nonprofit will be organized with a Board of Directors and with an officer structure such as a president, secretary, and treasurer. To make the overall transaction with the government work as smoothly as possible, the nonprofit may well place one or more members of the government entity that will have responsibility for administering the PWS – an organization similar to the Residual Effective Organization (“REO”) under A-76 – on the Board. Also, in order to assure that the government’s mission is not interfered with, especially in the event of a “surge” in activity when the government contractually will have the right to “reachback” to obtain the TBEs and former government assets, the nonprofit may designate a senior member of the government (who may or may not migrate with the employees) as a key person to coordinate workflow among the various parties under the TBC model.

#### 7. *Relationship between the Nonprofit TBC and the Government*

The nonprofit entity (the TBC) and the government will enter into a contract whereby the TBC will act as the fiduciary for the TBEs and will have responsibility for coordinating work under the PWS. The TBC may actually have responsibility for performing the PWS or that responsibility may reside with one or more private sector companies. In the former case, the TBEs would be employees of the TBC. In the latter case, the TBEs would become employees of the private sector company or companies. It is also possible that some of the TBEs would become employees of the TBC and others would become employees of the private sector companies.

The TBC would also be the fiduciary of the TBEs for as long as the TBEs performed work under the umbrella of the TBC model. The TBC would have a contractual arrangement with the Office of Personnel Management to assure that the TBEs' retirement, health, and life

insurance benefits are funded and remain in tack. As mentioned previously, there are a variety of ways that this arrangement can be structured in accordance with existing law and appropriations authority.

8. *Relationship between the Private Sector and the Government*

As discussed above, there may be instances when the nonprofit TBC will not perform any or some of the PWS. In those cases, private sector companies who will enter into a contractual relationship with the federal agency responsible for administering the PWS may perform the PWS. The rules for entering into such a contract are governed by the Federal Acquisition Regulations ("FAR"), which contemplate a variety of source selection methodologies ranging from free and open competition to sole source awards. Contractor source selection methodology will be made depending upon the facts and circumstances presented in any particular situation.

9. *Relationship between the nonprofit TBC and the private sector company or companies*

In those circumstances where one or more private sector companies perform the PWS totally or partially, a contractual agreement will be entered into between the TBC and them. The agreement will cover ways that the TBC will act as the fiduciary for the TBEs who are employees of the private sector company or companies. Under this agreement, the private sector company or companies will pay for the non-TBE portion of the pension, medical, and life insurance benefits that were previously covered by the federal government. The private sector company or companies will not include the TBEs within their existing benefit plans for these benefits. In this way, the TBEs will be treated as a separate class of employees within the company or companies. The TBC will receive the private sector payments directly, or track them, and assure that they are deposited into the OPM accounts set up for the TBEs.

11. *New Business Entities and Economic Growth*

One of the attractive features of the TBC Model is the emphasis placed on generating economic growth using the assets and people of the government activity that has been spun off. As mentioned above, the TBC can raise funds from a variety of sources, which can be to provide working capital for the TBEs who are trying to grow a business beyond the PWS. The funds are also available to fund TBEs who enter into new business ventures using the assets and intellectual property they possess to generate work in or near the government activity. The TBC will be able to facilitate not only funding for these new business entities but also creating business relationships with other nonprofit and academic institutions to allow for economic development in the locale.

**D. Rationale Supporting the Creation of the TBC Model**

1. *Strategies to Preserve Transferred Public Employee Benefits*

There are numerous statutes and other authorities that address the pension portability including: the Intergovernmental Personnel Act of 1970<sup>124</sup>; the United States Enrichment Corporation Privatization Act<sup>125</sup>; the Employee Pension Portability and Accountability Act

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<sup>124</sup> See Intergovernmental Personnel Act of 1970, Pub. L. No. 91-648, 84 Stat. 1909 (1971).

<sup>125</sup> See United States Enrichment Corporation Privatization Act Pub. L. No. 104-134 (1996).

(pending); and the I.R.S. Private Letter Ruling dated April 21, 1999.<sup>126</sup> Such authority allows for the temporary and/or permanent portability of government pension and health benefits even though former government employees are now working in the private sector. While there is nothing directly on point to allow government to summarily allow its former employees to continue participating in the governmental benefits plan, there is nothing specifically prohibiting such action by the government.

## 2. *The Intergovernmental Personnel Act of 1970*

The first statutory and/or regulatory basis to fairly and effectively deal with the issue of pension portability under the TBC Method is the Intergovernmental Personnel Act of 1970 (IPA).<sup>127</sup> Under the IPA, the government would be authorized to temporarily transfer its government employees to a nonprofit organization under the TBC Model for up to four years, and still protect such employees' government pension participation and accrual rights while these employees are on temporary assignment to the nonprofit organization.<sup>128</sup>

In particular, government employees that are serving on leave without pay would be entitled to continuation of their retirement, life insurance, and health benefits coverage under the Civil Service or other applicable systems as long as they currently paid the employee contribution into the appropriate fund or system.<sup>129</sup> The employer contribution would be paid by the federal agency originating the assignment for all three types of coverage.<sup>130</sup> If the assigned employee or their beneficiaries elected to receive benefits under State or local systems instead, then federal health, life insurance and retirement benefits would not be authorized.<sup>131</sup>

However, IPA, as amended, is only a temporary solution to the pension portability issue. Since the IPA only allows assignment of government employee for up to four years maximum, this is only an interim resolution to the pension portability issue under the TBC Method. If the government were to use this statute to facilitate the TBC, then over the next few years legislation such as, a technical amendment to the IPA or a new statute may need to be passed. Such a new development would be necessary in order to make the final transition of government employees into the private sector while allowing them to continue to participate in the government plan.

## 3. *The United States Enrichment Corporation Privatization Act*

Another statutory basis for the government to rely on in allowing federal employees to continue their participation and accrual in federal benefits plans on the permanent basis under the TBC Method is the United States Enrichment Corporation Privatization Act (USECPA).<sup>132</sup> The USECPA was passed as an amendment to the Atomic Energy Act of 1954 and provides for the transfer of the interest of the United States in the

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<sup>126</sup> See Priv. Ltr. Rul. (April 21, 1999).

<sup>127</sup> See Intergovernmental Personnel Act of 1970, Pub. L. No. 91-648, 84 Stat. 1909 (as amended by 5 C.F.R. § 334 *et seq.*).

<sup>128</sup> See *id.*

<sup>129</sup> See *id.*

<sup>130</sup> See *id.*

<sup>131</sup> See *id.*

<sup>132</sup> See United States Enrichment Corporation Privatization Act Pub. L. No. 104-134.

United States Enrichment Corporation ("the Corporation") to the private sector.<sup>133</sup> The transfer would be done in a manner that provides for (1) the long-term viability of the Corporation; (2) the continuation by the Corporation of the operation of the Department of Energy's gaseous diffusion plants; (3) the protection of the public interest in maintaining a reliable and economical domestic source of uranium mining, enrichment and conversion services; and (3) to the extent not inconsistent with such purposes, the maximum proceeds to the United States. <sup>134</sup>The USECPA specifically addresses the issue and treatment of employee benefits after the transfer of a government operation to the private sector.

An employee of the Corporation that was subject to either the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS) on the day immediately preceding the transition date had the option to elect (1) to retain the employee's coverage under either CSRS or FERS, as applicable, in lieu of coverage by the Corporation's retirement system; or (2) to receive a deferred annuity or lump-sum benefit payable to a terminated employee under CSRS or FERS, as applicable. An employee that made the election had the option to transfer the balance in the employee's Thrift Savings Plan account to a defined contribution plan under the Corporation's retirement system, consistent with applicable law and the terms of the Corporation's defined contribution plan.

The Corporation then paid to the Civil Service Retirement and Disability Fund: (1) such employee deductions and agency contributions as are required for those employees who elected to retain their coverage under either CSRS or FERS; (2) such additional agency contributions as was determined necessary by OPM to pay, in combination with the sums above, the "normal cost" (determined using dynamic assumptions) of retirement benefits for those employees who elect to retain their coverage under CSRS, with the concept of "normal cost" being used consistent with generally accepted actuarial standards and principles; and (3) such additional amounts, not to exceed two percent of the amounts under (1) and (2) above, as was determined necessary by OPM to pay the cost of administering retirement benefits for employees who retire from the Corporation after the transition date under either CSRS or FERS, for their survivors, and for survivors of employees of the Corporation who die after the transition date.<sup>135</sup> The Corporation also paid to the Thrift Savings Fund such employee and agency contributions as are required for those employees who elected to retain their coverage under FERS. <sup>136</sup>

Any employee of the Corporation who was subject to the Federal Employee Health Benefits Program ("FEHBP") on the day immediately preceding the transition date and who elected to retain coverage under either CSRS or FERS had the option to receive health benefits from a health benefit plan established by the Corporation or continued without interruption coverage under the FEHBP, in lieu of coverage by the Corporation's health benefit system. The Corporation paid to the Employees Health Benefits Fund: (1) such employee deductions and agency contributions as are required by section 8906 (a)--(f) of title 5, United States Code, for those employees who elect to retain their coverage under FEHBP; and (2) such amounts as are

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<sup>133</sup> See *id.*

<sup>134</sup> See *id.*

<sup>135</sup> The amounts shall be available to OPM as provided in section 8348(a)(1)(B) of title 5, United States Code.

<sup>136</sup> This requirement would be under § 8432 of title 5, United States Code.

determined necessary by the Office of Personnel Management to reimburse the Office of Personnel Management for contributions under section 8906(g)(1) of title 5, United States Code, for those employees who elect to retain their coverage under FEHBP.

The USECPA provides an optimal framework for the government to rely on in authorizing its former government employees to continue to participate in and accrue federal benefits even if such employees are working under the umbrella nonprofit organization or in the private sector. Whereas in the case of the IPA, federal employees are only allowed to temporarily participate in the federal benefits plan, the USECPA went one step further in allowing such participation and accrual on a permanent basis. The USECPA is an outstanding method to follow and affords the government the ability to optimize its human resources by protecting their federal benefits if such employees make the transition to a TBC or the private sector.

#### 4. *The Employee Pension Portability and Accountability Act*

The Employee Pension Portability and Accountability Act (EPPAA)<sup>137</sup> is a further example of how certain pending legislation is addressing the loss of benefits situation in the public sector where employees transfer jobs from one state or local government to another state or local government. In particular, Section 16 of the EPPAA would permit employees of State and local governments, particularly teachers, who often move between states and school districts in the course of their careers to make tax-free transfers from their section 403(b) tax-sheltered annuities of governmental section 457 plans to purchase service credits under their defined plan.

This credit feature, where teachers would be able to buy credits in an alternative system creates a dilemma, in that this credit system would result in an unfunded pension liability issue for the government. The TBC Method addresses the issue of the unfunded pension liability, where under the Method the debt would not be accelerated but would remain outstanding and the federal government would be allowed to pay back the credits in small increments. Further, this "buy-out" type of system in the EPPAA does not allow for the maintenance or the ability of such public sector employees to accrue benefits in its previous pension and health plans. In contrast, the TBC Method is a superior and unique solution because the Method allows the former federal employees to continue to participate in and accrue federal benefits, in a sense, such employees are treated as having tenured status.

#### 5. *I.R.S. Private Letter Ruling, April 21, 1999*

Local officials are also addressing the critical issue of pension portability when certain local public services are privatized. For instance, in a I.R.S. Private Letter Ruling dated April 21, 1999, the City of Milwaukee (the City) requested a ruling by the Internal Revenue Service as to whether a pension plan will still be considered a governmental plan under Section 414(d) of the Internal Revenue Code. This was even though the City and a company entered into an agreement where company would operate the City's Wastewater system and 300 of the City's employees would become employees of Company B. The City passed an ordinance allowing these transferred employees

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<sup>137</sup> The EPPAA was introduced as part of H.R. 1102 on March 22, 1999, by Congressman Richard E. Neal of Massachusetts, and contained in the Administration's fiscal year 2000 budget submission to the 106<sup>th</sup> Congress as part of H.R. 1102. At this time, the Act is still pending in Congress.

who participated in the City's benefits plan to continue to accrue benefits under the plan based on their service and compensation with the company. The IRS determined that the plan would still be considered a governmental plan because the City will be retaining most of the control on the activities of Company B, that the governmental benefits plan would be managed by the City with the Company sending benefit payments to the City, and that the arrangement between the City and Company B was only for a 10 year period with the employees becoming City employees again.

The Private Revenue Ruling only provides a temporary solution to the pension portability issue. The City employees would still be allowed to participate in the government benefits plan while employed by a private corporation during a limited duration of ten years. The TBC Method differs from the method above because the TBC Method allows not only for the continued participation, on a permanent basis, in the Federal government benefits plan, but the accrual of such benefits.

## **E. Examples...Well, Not Quite**

### *1. Department of the Army Logistics Modernization*

The Department of the Army (the "Army"), faced with the fact that it had an aging logistics system, decided to outsource this function to Computer Science Corporation (CSC) for \$680 million. The Army waived the OMB A-76 circular requirements for competition between the 460 federal employees at the Saint Louis and Chambersburg software design centers and a contractor before outsourcing.<sup>138</sup> This move was met with opposition from unions. Through bargaining the Army, CSC and the union settled on a soft landing for the civilian workers.<sup>139</sup> In particular, "[t]hose employees were guaranteed similar jobs at CSC -- at the same location with comparable pay, benefits and retirement programs -- for at least three years," "but they still can be fired for poor performance."<sup>140</sup> Further, "[l]aid-off employees who elected to work for CSC received signing bonuses."<sup>141</sup> "Of the 460 employees, 77 remained at St. Louis or Chambersburg as federal employees to monitor the contract; 214 were laid off and got \$15,000 bonuses when they accepted jobs with CSC; 82 took early retirement and received \$25,000 government buyouts; and 87 accepted jobs elsewhere in the federal government."<sup>142</sup>

The modernization of the Army's logistical detachments is a prime example, on a large scale, of how the federal government was able to privatize a non-core function and still protect the jobs of its former civilian workers through negotiation with the private sector. However, this effort differs from the TBC Method, in that this resource optimization effort failed to protect the federal benefits plans of the former civilian workers. While such civilians were given the option of staying with the federal government or retiring/resigning to join CSC, the Army did not provide an avenue to allow such civilian workers to continue to participate in the federal benefits program if

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<sup>138</sup> See Brian Friel, *Army outsources logistics modernization program*, GovExec.com, January 4, 2000 (visited April 5, 2001).

<sup>139</sup> See George Cahlink, *Supply and Demand*, GovExec.com, November 1, 2000 (visited April 5, 2001).

<sup>140</sup> *Id.* at 4, 5.

<sup>141</sup> *Id.*

<sup>142</sup> *Id.* at 5.

such workers decided to join CSC instead of staying with the Army. The TBC Method takes this resource optimization example one step further, and allows former federal employees continued participation in federal government benefits programs after such employees make the transition into private sector employment.

## 2. *SSPORTS Resource Optimization Activities*

As discussed above, the Naval Sea System Command (NAVSEA) of the United States Department of the Navy privatized the Supervisor of Shipbuilding, Conversion and Repair Portsmouth Virginia (SSPORTS) Environmental Detachments in Vallejo, California and Charleston, South Carolina.<sup>143</sup> NAVSEA assessed whether it was feasible for the Detachments to be privatized, i.e. operate as an independent entity in the private sector in a manner that would (1) meet the cost and technical objectives of current Federal Government clients; (2) determine what actions should be taken by the Detachments, SSPORTS, and NAVSEA to enable successful and rapid transition to the private sector; and (3) determine whether the employee ownership of the new private company was viable through an Employee Stock Ownership Plan (ESOP).<sup>144</sup>

It was determined, however, that because the environmental clean-up market was consolidating, it would have been too difficult to start up a new company alone.<sup>145</sup> Based on this assessment, in September of 1999, two environmental cleanup teams, totaling about 350 civilian workers at the closing Navy shipyards, left the government for the private sector.<sup>146</sup> Most of the Vallejo employees were hired as teams for private sector organizations to continue the work they had been doing as federal employees, with most of the workers becoming employees of Roy F. Weston, Inc. the nation's fifth largest environmental consulting company.<sup>147</sup> The federal employees were to receive the same salaries and comparable benefits packages.<sup>148</sup> The "Charleston" workers elected to join the South Carolina Research Authority (SCRA), a nonprofit organization chartered by the state to attract scientific and research business to South Carolina.<sup>149</sup> The SCRA also provided an attractive benefits package to former Federal employees making the transition to SCRA.

The key difference between the SSSPORTS resource optimization activity and the TBC Method is the manner in which the employee benefits were dealt with. Typically in a Federal governmental setting, the benefits received by those employees are more comprehensive than for employees in the private sector. This inequity is because of the fact that since the Federal government is unable to match private sector salaries, it compensates through excellent benefits packages. The TBC Method recognizes and addresses this dilemma by allowing such former Federal employees the option to continue their participation and accrual in the Federal benefits program even after such employees opt to make the transition to the nonprofit umbrella organization or private sector enterprise.

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<sup>143</sup> See George Cahlink, *Shipyards Workers Go Private to Keep Jobs*, FEDERAL TIMES (August 2, 1999).

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> *Id.*

<sup>148</sup> *See id.*

<sup>149</sup> *Id.*

### 3. *County of San Diego IT Resource Optimization*

In the spring of 2000, the County of San Diego (the County) selected a consortium of four companies to create a "virtual" government for the citizens in the County named the Pennant Alliance. The County outsourced all of its computer and telecommunications operations to the consortium of private companies, projected to cost over \$644 million over the next seven years.<sup>150</sup> In order to entice former County employees to make the transition into the Pennant Alliance, these employees received "retention bonuses and salary increases, and their county retirement and health insurance benefits went with them to the private sector" and "were guaranteed two years of employment."<sup>151</sup> After the final transition of the IT services into the Pennant Alliance, 220 County employees decided to take jobs with either Computer Sciences Corporation or SAIC, 80 employees took early retirement or severance packages, and about 20 people are now left in the county information technology department.

#### **F. Summary of the TBC Model**

While the TBC Model is a new business method, it can actually be considered a composite of a number of transactional methodologies that have been used successfully in the recent past. As discussed earlier, examples include the Naval Air Warfare Center in Indianapolis, the Navy Environmental Detachment in Charleston, South Carolina, the United States Investigative Services (background investigators from the Office of Personnel Management) and several local government initiatives including the City of Milwaukee's wastewater management services and the County of San Diego's Information Technology capability Outsourcing. The TBC Method is very scalable – being able to handle a small group of employees or assets as well as entire installations or activities. The methodology lends itself to involving local governments and economic development oriented nonprofit organizations as well as universities and foundations as the nucleus for former government assets and workers who are transitioned into productive non-government work while assuring that legitimate government mission needs are met. Finally, the TBC Method handles the people issues associated with a sourcing decision gracefully – providing such TBEs with a soft landing at a reduction in the cost to the taxpayer.

### **PART THREE: CONCLUSION**

Thus, the individual facing the prospects of dealing with an A-76 competition does have a few reasonable alternatives to consider. In each of these cases -- A-76, ESOP, or TBC -- the government needs to develop a performance work statement as an articulation of what its needs are on a going forward basis over the next three to five years or longer depending upon the length of the contract being contemplated. During the time that the PWS is being developed, the individual and his or her management can and should consider a range of alternatives that more appropriately achieve the goals of the government, its employees, and the taxpayers. As discussed above, in circumstances where a business case can be made, use of either an ESOP or TBC approach may well be preferable to undergoing an A-76 competition. Both an ESOP and TBC transaction can be conducted substantially faster than an A-76 competition. Especially in the case of a TBC, the savings will occur more quickly than under an A-76; and in either case the transaction can be structured to provide the government with substantially more management agility than it now realizes under A-76

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<sup>150</sup> See Ellen Perlman, *Taking Tech Private*, *Governing.com*, May 2000 (visited April 5, 2001).

<sup>151</sup> *Id.*

competitions. And, more importantly, the federal government employee will have a "soft landing" and not be subjected to the harsh prospect of seeing one-third of the staff positions being eliminated.

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