

# Rules and Regulations

Federal Register

Vol. 72, No. 210

Wednesday, October 31, 2007

This section of the FEDERAL REGISTER contains regulatory documents having general applicability and legal effect, most of which are keyed to and codified in the Code of Federal Regulations, which is published under 50 titles pursuant to 44 U.S.C. 1510.

The Code of Federal Regulations is sold by the Superintendent of Documents. Prices of new books are listed in the first FEDERAL REGISTER issue of each week.

## DEPARTMENT OF AGRICULTURE

### Food and Nutrition Service

#### 7 CFR Parts 210, 215 and 220

[FNS-2007-0003]

RIN 0584-AD38

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

**AGENCY:** Food and Nutrition Service, USDA.

**ACTION:** Final rule.

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

**DATES:** This rule is effective November 30, 2007. However, implementation will

be phased in for existing contracts. Implementation timeframes are discussed more fully in section III of the **SUPPLEMENTARY INFORMATION.**

**FOR FURTHER INFORMATION CONTACT:** Melissa Rothstein, Branch Chief, or Lynn Rodgers-Kuperman, Program Analyst, Child Nutrition Division, Program Analysis and Monitoring Branch, Food and Nutrition Service, Department of Agriculture, 3101 Park Center Drive, Room 640, Alexandria, Virginia 22302-1500. FAX (703) 305-2879; telephone (703) 305-2590.

#### **SUPPLEMENTARY INFORMATION:**

##### **I. Background**

On December 30, 2004, FNS published a Notice of Proposed Rulemaking (proposed rule) in the *Federal Register* (69 FR 78340) intended to remedy the deficiencies in school food authority procurement practices that are undermining full and open competition and resulting in unallowable uses of nonprofit school food service account funds. The December 2004 rule proposed to:

(1) Clarify allowable nonprofit school food service account expenditures for costs resulting from cost reimbursable contracts or cost reimbursable contract provisions;

(2) prohibit contract terms that allow payments from the nonprofit school food service account in excess of the contractor's actual net allowable costs, computed by deducting certain rebates, discounts and other credits; and

(3) require State agency review and approval of all contracts between school food authorities and food service management companies prior to their execution.

As discussed in the preamble to the proposed rule, most school food authorities manage the National School Lunch Program, School Breakfast Program and Special Milk Program on their own. However, some school food authorities choose to contract with a commercial enterprise to manage the programs. These commercial enterprises are collectively known as food service management companies.

In regulations published on January 18, 1969, FNS first permitted school food authorities operating under contract with a food service management company to participate in the National School Lunch Program under a pilot program (34 FR 807). On

March 1, 1969, FNS issued prototype agreements for use by these school districts (34 FR 3704-3709). At that time, the only form of payment to a food service management company was a fixed price per plate or other meal equivalency served or delivered that included the contractor's full costs and profit. The food service management company was required to purchase food for the school food authority with invoices sent directly to the school food authority for payment. The cost of such food purchases was limited to the amount agreed upon between the food service management company and the school food authority (34 FR 3704). In effect, this contract was a cost reimbursable contract with a cap on costs plus a fixed management fee. Over time, the limit on costs was abandoned. Currently, food service management company contracts are either an inclusive fixed price per meal, or cost reimbursable with a fixed fee (without a cap on costs) contracts. We understand that the majority of all food service management company contracts are cost reimbursable with a fixed fee.

School food authorities use funds from the nonprofit school food service account to pay for costs incurred under both self-managed and food service management company-contracted programs. The funds in the nonprofit school food service account come from federal and nonfederal sources. The federal funds are provided as reimbursements from the U.S. Department of Agriculture (Department) for meals and milk meeting the requirements in 7 CFR 210.10, 215.7 and 220.8 that are served to eligible children. The primary sources of nonfederal revenue are student payments, adult payments and a la carte sales revenue. Additional funding sources include State and local funds and sales revenue from vending and catering activities. Regardless of the source, the school food authority must retain all of these revenues in the restricted nonprofit school food service account and may only expend these revenues for the allowable costs of the school food authority's nonprofit school food service program.

When procuring goods or services, including the use of a food service management company, school food authorities must conduct procurements in a manner that provides full and open

competition. Full and open competition is necessary to provide a "level playing field" so that all potential contractors have the opportunity to win the contract award. Competition is impaired when potential contractors lack the necessary information to properly identify allowable and unallowable costs and establish the best and most responsive price, or when the procurement is written in a way that inhibits the ability of potential contractors to submit bids. A properly conducted procurement results in the school food authority obtaining the best product at the best price.

Cost allowability is determined using the applicable program and Departmental regulations (7 CFR parts 210, 215, 220, 3016 and 3019, as applicable) and Office of Management and Budget (OMB) Cost Circulars (A-87 Cost Principles for State, Local Governments and Indian Tribal Governments, or A-122 Cost Principles for Non-profit Organizations, as applicable). The determination regarding allowability is made, in part, based on the character of the recipient (i.e., school food authority) incurring the costs under the Federal program. As school food authorities are generally local governmental entities, all costs would, therefore, be subject to the principles found under OMB Circular A-87. In cases where the school food authority is a private non-profit (e.g., in the case of a parochial school), OMB Circular A-122 would apply. Further discussion of this matter is found later in this preamble (see *Applicability of the OMB Cost Circulars to school food authority contracts* under Section II of this preamble).

The proposed rule clarified that only costs resulting from cost reimbursable contracts or cost reimbursable contracts or cost reimbursable contract provisions that meet applicable cost allowability requirements are allowable nonprofit school food service account expenditures. The proposed rule required that allowable contractor costs paid from the nonprofit school food service account be net of all discounts, rebates and applicable credits. In addition, the proposed rule required contractors to provide sufficient information to permit the school food authority to identify allowable and unallowable costs and the amount of all such discounts, rebates and credits on invoices and bills presented for payment to the school food authority. This requirement serves to make the identification of discounts, rebates and credits more transparent to school food authorities and allows for proper use of nonprofit school food service account

funds. This requirement should not place an additional burden on contractors as they already track the costs that are billed to school food authorities and have accounting and billing systems in place for school food authority contracts. Under Generally Accepted Accounting Principles and good business practices, these contractors also must maintain systems to track and report discounts, rebates and credits.

#### *OIG Audit Reports*

The proposed rule was prompted in part by two audits released by the Office of Inspector General (OIG) in 2002, both of which identified deficiencies in school food authority procurement practices that are undermining full and open competition and resulting in unallowable uses of nonprofit school food service account funds. The first audit, released in February 2002 as Audit Report 27010-3-AT, identified a number of instances where a cooperative buying group, using nonprofit school food service account funds, failed to conduct procurement transactions in a manner that provided for full and open competition. For example, one cooperative buying group failed to include all items to be purchased in its bid solicitation and instead purchased items directly from the contractor outside of the terms of the contract. To purchase directly from the contractor without the benefit of a proper procurement limits full and open competition, as other potential contractors are eliminated from consideration.

The second audit (OIG Audit Report 207601-0027-CH, released in April 2002) revealed problems in several cost reimbursable contracts between school food authorities and food service management companies. OIG found contracts between school food authorities and food service management companies that lacked controls as to exactly how the company would determine the allowability of costs charged to the school food authority, including how the company would provide the school food authority with the benefits of purchase discounts, rebates, and credits in the determination of net costs. The failure of a school food authority to describe its cost reporting requirements fully in its solicitation document undermines full and open competition by placing unreasonable burdens on potential contractors. Without adequate details on how it must report costs to the school food authority, a potential contractor lacks the information needed to properly establish the fixed price component

(management fee) of its offer. In addition, school food authorities cannot determine whether nonprofit school food service account funds may be used to pay all or only part of the costs billed by the contractor. In other cases, OIG found that even though the school food authority's procurement documents required the return of such discounts, rebates, and applicable credits, the food service management company was permitted to keep the discounts and rebates earned through purchases billed to the school food authority. Allowing the food service management company to keep these funds was a material change to the contract; material changes require a rebidding of the contract. The net effect is that excess charges are made against the food service account, thereby diminishing food service resources.

#### *Comments in General*

FNS received 16 comments on the proposed rule within the allotted 60-day comment period. Of the 16 commenters, seven were State agencies, three were food service management companies, and the rest were trade and professional organizations and consultants.

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

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

regulations consistent with the National School Lunch Program regulations.

## II. Discussion of the Rule's Provisions and Related Comments

### Definitions

The proposed rule added definitions of "Applicable credits," "Contractor," and "Nonprofit school food service account" to 7 CFR 210.2, 215.2 and 220.2. All subsequent references to regulatory sections are to title 7, Code of Federal Regulations, unless otherwise indicated.

"Applicable credits" was defined with a cross-reference to definitions provided in OMB Circulars A-87 and A-122. The proposed rule at §§ 210.21(e)(1)(i), 215.14a(d)(1)(i) and 220.16(e)(1)(i) required that cost reimbursable contracts include a provision that costs paid to the school food authority's contractor be net of all discounts, rebates and other applicable credits received by the contractor. Examples of applicable credits are discount incentives for volume purchases, credits for returned goods, and rebates paid for the purchase of specific goods.

Several commenters asked for clarification on whether earned income would be considered an "applicable credit" under the proposed definition. In general, earned income is a payment from the manufacturer to the distributor for work performed by the distributor on behalf of the manufacturer. Some examples of earned income include payments made to a distributor for promoting new products, hosting trade shows, distributing promotional information, or carrying a particular product in inventory. In each of these cases, the distributor must perform some service to receive the payment from the manufacturer. This type of earned income is not related to purchases made by a school food authority using its nonprofit school food service account and, therefore, is not considered an applicable credit.

Three commenters asked for clarification on whether a prompt payment discount would be considered an applicable credit. A prompt payment discount is an applicable credit to the nonprofit school food service account only if the school food authority earns the reduction by paying the bill or by providing advance funds to another party to pay the bill on its behalf. We understand that in the majority of school food authority cost reimbursable contracts, distributors and food service management companies obtain goods from suppliers, are billed by those suppliers, pay the suppliers and then

deliver the goods at some later point in time to the school food authority. In these arrangements, the prompt payment discounts are not applicable credits to the school food authority.

On the proposed definition of "contractor," a number of commenters asked for confirmation that the definition includes all contractors to the school food authority, not just food service management companies. The commenters are correct.

Commenters also wanted clarification on whether a purchasing cooperative meets the definition of a contractor. A school food service purchasing cooperative, an organization formed by school food authorities to conduct purchases, is not a contractor to its school food authority members, but instead acts as their purchasing agent. As an agent, the purchasing cooperative must follow the same rules in acquiring goods and services that its school food service members would follow should the members make the acquisitions themselves.

Another type of purchasing cooperative is a cooperative buying group, which is an already existing public, for-profit or nonprofit buying group which usually requires the payment of a fee to become a member. In exchange for the membership fee, the cooperative buying group offers its members pre-selected items at prices that are generally lower than the price paid at retail establishments for the same items. While the purchase of a membership from the cooperative buying group might create a contractual relationship between the cooperative buying group and the school food authority, a cooperative buying group is not considered a "contractor" under the program regulations.

One comment was received on the proposed rule's definition of "Nonprofit school food service account." The proposed rule established the definition of "Nonprofit school food service account" to mean the restricted account in which all of the revenue from the food service operations conducted by the school food authority principally for the benefit of school children is retained and used only for the operation or improvement of the nonprofit school food service. The commenter requested the word "restricted" be further defined. No change to this definition is being made in this final rule because the nature of the restrictions on the use of nonprofit school food service account funds are explained within the definition itself and at § 210.14(a).

In addition to the requests for clarification discussed above, commenters also requested that

definitions be added to the final rulemaking for "cost contract," "fixed price contract," "cost reimbursable contract" and "fixed fee." The terms "cost reimbursable contract" and "fixed fee" have been defined in this final rule, because FNS will need to use these terms in regulatory language. However, we did not define the other two terms. The term "cost contract" is already defined in Department regulation 7 CFR 3016.3. FNS does not see the need to use the term "fixed price contract" in the National School Lunch, Special Milk or School Breakfast Program regulations, and has therefore elected not to define that term in regulatory language. (Please note, however, that while the term "fixed price contract" is not used in the regulations, it is a commonly used type of contract in these programs, and will be used at various times in this preamble.) Thus, the final rule adds definitions for "cost reimbursable contract" and "fixed fee" based on existing regulations, accounting definitions and previously issued policy and guidance.

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

### Procurement Procedures

As a general rule, all procurements in the School Nutrition Programs, whether for goods or services, must be competitive. Sections 210.21(c), 215.14a(c), and 220.16(c) of the proposed rule included the requirement that, in conducting procurements, State agencies and school food authorities may use their own procurement procedures which reflect applicable state and local laws and regulations, as long as procurements made with nonprofit school food service account funds meet the standards set forth in the program regulations and §§ 3016.36(b) through 3016.36(i), § 3016.60 and §§ 3019.40 through 3019.48, as applicable, and in the applicable OMB Cost Circulars. We have modified the language of §§ 210.21(c), 215.14a(c) and 220.16(c) to more accurately reflect the provisions of §§ 3016.36(a) and 3016.60(a), which specify that State grantees may elect to follow either the State laws, policies and procedures, or the procurement standards for other governmental grantees and subgrantees in accordance with § 3016.60(b) through (i). Regardless of the option selected,

States must ensure that all contracts include any clauses required by Federal statutes and executive orders and that the requirements of § 3016.60(b) and (c) are followed.

Two commenters raised issues with procurement procedures in general. The first asked that we consider permitting cost plus percentage of cost contracts. The commenter's rationale for allowing this procurement method was that this form of contract costing may be the most cost effective procedure for school food authority bidding. In a cost plus percentage of cost contract, the contractor earns its fee based on a percentage of the cost of goods it sells under the contract. This contract cost method is prohibited government-wide because this form of contract pricing provides a financial incentive for the contractor to increase costs.

The second commenter expressed concern that our position that competition is required for all procurements would prevent school food authorities from taking advantage of "value added" products or consider factors other than price in awarding a contract. Although the proposed rule did not directly address this issue, this comment reflects a misunderstanding of procurement practices which we will address briefly in this preamble and in future guidance and training.

While a potential contractor may indeed have a better ("value added") product, if that product does not meet solicitation specifications, the school food authority cannot use the phrase "value added" to circumvent proper procurement procedures. It is not appropriate for a school food authority to select products that do not meet solicitation requirements. If the school food authority determines that the value added product is more appropriate than the product it specified in its procurement solicitation, the school food authority must issue a new solicitation or wait until its next bid cycle to change its specifications. This does not mean, however, that a school food authority must consider a product that does not meet the specifications even if that product has the lowest cost.

Another concern raised by this commenter and others was that school food authorities could be penalized if they failed to use either sealed bidding or competitive proposals to purchase every item needed during the school year. This is not the case, but does represent a common misunderstanding that the term "competitive procurement" means that either the sealed bid or competitive proposal method must be used. Some form of competition is required for every

purchase, but not every purchase is subject to the formal (sealed bid or competitive proposal) solicitation methods. There are many items that are purchased in such small quantities that it is not cost effective for the school food authority to conduct a formal procurement to acquire these items. However, just because a purchase will not meet the formal procurement threshold does not mean the school food authority is exempt from competitively procuring the purchase. In these situations, the school food authority would use simplified small purchase procedures. Simplified small purchase procedures are those relatively simple and informal procurement methods for securing services, supplies, or property that may be used when the anticipated acquisition will fall below the Federal simplified acquisition threshold currently set at \$100,000. Informal or small purchase procedures, discussed at § 3016.36(d), are relatively simple and informal practices that are not as rigorous as formal procurement procedures, but that still provide competition. For example, a school food authority seeking to purchase several thousand dollars worth of office supplies would not have to issue a formal solicitation document and publicize it widely. Rather, the school food authority could simply fax its list of needed supplies to at least three local suppliers, and then compare the prices received from each. School food authorities must determine and apply any State or local thresholds that are lower, and therefore more restrictive, than the current Federal small procurement threshold of \$100,000.

#### *Provisions Required in Cost Reimbursable Contracts*

The proposed rule required, in §§ 210.21(e)(1), 215.14a(d)(1), and 220.16(e)(1), that school food authorities include specific solicitation and contract provisions in cost reimbursable contracts or contracts with cost reimbursable terms. These proposed provisions included the requirement that allowable costs be paid to the contractor net of all discounts, rebates, and applicable credits; and that the contractor individually identify on bills and invoices, and maintain documentation of, discounts, rebates, and applicable credits. In addition, the proposed provisions included the requirement that the contractor separately identify for each cost submitted for payment to the school food authority the amount of the cost that is allowable (i.e., can be paid from the nonprofit school food service account) and the amount that is

unallowable, as determined in accordance with the applicable regulations and OMB cost circulars.

These proposals, taken together, are intended to provide school food authorities with the information they need to identify the net allowable portion of their contract costs that can be funded from the nonprofit school food service account, and the amount of unallowable contract costs that must be funded from other sources. These proposals are also intended to inform contractors about these reporting requirements up front.

#### *Applicability of Contract Provisions to Different Contract Types*

A number of comments were received regarding the applicability of these solicitation and contract terms to fixed price contracts or to the fixed fee components of cost reimbursable contracts. A fixed price contract is a contract cost method that establishes a fixed price, usually on a per unit basis, for the goods and/or services provided by the contractor for the duration of the contract, including renewals. A fixed fee is often one component of a cost reimbursable contract.

We did not propose, nor does this final rule require that these same solicitation and contract provisions relating to discounts, rebates, and applicable credits be included in fixed price solicitations or in the resulting fixed price contracts, because contractors have already taken discounts, rebates and other credits into consideration when formulating their prices for fixed price contracts. The same holds true for the fixed fee component of a cost reimbursable contract. However, the cost reimbursable components of any contract would be subject to the requirement that specific provisions relative to discounts, rebates and applicable credits be included.

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

Several commenters suggested that FNS mandate the use of fixed price contracts. Based on anecdotal information, some State procurement statutes and regulations already limit

public school food authorities to fixed price contracting, while other State agencies have mandated this form of contracting for specific acquisitions, such as acquiring the services of a food service management company. However, mandating the use of fixed price contracts on a national basis is not in the best interest of the school nutrition programs. State agencies and school food authorities, not FNS, should determine whether acquisitions are best suited to fixed price or cost reimbursable contracts.

Commenters also expressed concern that by not subjecting fixed price contracts to the provisions of the proposed rule, school food authorities would not be required to determine the allowability of costs resulting from fixed price contracts. As stated above, fixed price contracts are not subject to the provision of the proposed rule requiring that allowable contractor costs paid from the nonprofit school food service account be net of all discounts, rebates, and applicable credits because contractors have already taken into consideration factors such as discounts, rebates and other credits when formulating their prices for fixed price contracts. However, the net cost factor is only one aspect used in determining allowable costs. Expenditures from the nonprofit school food service account for fixed price contracts must still meet the general requirements for allowable costs. To be allowable, a cost must be necessary, reasonable, and allocable.

For example, a school seeks to contract for janitorial supplies for the entire school building through a single procurement solicitation. The contract will be awarded on a fixed price per item basis. Under the allowable cost rules, the costs associated with the janitorial supplies purchased for use by the school food service would be an allowable expenditure from the nonprofit school food service account, but costs associated with the janitorial supplies purchased for the rest of the school would not, as they are not allocable to the nonprofit school food service account. The fact that the contract was fixed price would not supersede the cost requirement that to be allowable, a cost must be necessary, reasonable and allocable to the nonprofit school food service. The same principles would apply to the fixed price fee of a cost reimbursable with fixed fee contract.

One commenter raised the issue of the risks contractors, particularly food service management companies, incur when including guaranteed return provisions in contracts, and requested that contracts containing such

provisions be considered fixed price for purposes of the final rulemaking. The commenter asserted that providing a guaranteed return causes its company to take profit and loss risks similar to what it assumes in fixed price contracts. The commenter further offered that since a company assumes financial risk by agreeing to the guaranteed return provision, it would be inequitable to treat the contract as cost reimbursable. Instead, the commenter indicated the contract should be viewed as fixed price, thus eliminating the need for the company to include discounts, rebates, and other applicable credits on bills and invoices submitted to the school food authority.

We disagree. Guaranteed return provisions do not substantially alter the terms of a contract enough to convert it from cost reimbursable to fixed price. Furthermore, guaranteed return provisions are neither new nor unique to the School Meal Programs, nor are these provisions limited to cost reimbursable contracts. By entering into contracts with guaranteed return provisions, the contractor willingly agrees to accept the risk. In their current form, most of these guaranteed return provisions do not place successfully performing contractors at risk. As the commenter noted, guaranteed return provisions provide a financial assurance that certain contractual promises made to the school food authority will be met. There is no Federal requirement that a contract be drafted to eliminate all possible risk to a contractor, nor is a school food authority required to indemnify its contractor against all potential risks that might occur, particularly those that the contractor has agreed to accept.

No changes are being made in this final rule based on these comments.

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

Most commenters supported the proposed rule's provisions limiting expenditures from the nonprofit school food service account to net allowable costs. However, there did appear to be some misunderstanding of this proposal. Some commenters asserted that we were proposing that discounts, rebates, and other applicable credits must be returned to the school food authority. Another commenter asserted that the proposal that contractors identify allowable and unallowable costs on invoices would substantially alter the current economic structuring of transactions between food service management companies and school food authorities.

To clarify, this provision does not prevent a school food authority from entering into a contract that results in unallowable costs. It does, however, prohibit the school food authority from using nonprofit school food service account funds to pay any amount above net allowable costs. The decision regarding whether discounts, rebates, and other applicable credits are returned to the school food authority is a decision between the school food authority and its contractor. However, the school food authority can only use nonprofit school food service account funds to pay for costs that are net of discounts, rebates, and applicable credits.

To prevent any future misunderstanding of this distinction, we have amended this final rule at §§ 210.21(f)(1)(i), 215.14a(d)(1)(i) and 220.16(e)(1)(i) to clarify that the limitations on the payment of allowable and unallowable costs pertain only to expenditures from the nonprofit school food service account.

#### Confidentiality and Disclosure of Discounts, Rebates, and Credits

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

Three commenters raised concerns with the protection of confidential business arrangements when reporting discounts, rebates and other applicable credits. FNS is sensitive to the commenters' concerns related to confidential business relationships. We agree with the commenters that the reporting of discounts, rebates and other applicable credits should not compromise business relationships that have been promised confidentiality. We were aware that such confidential business relationships could exist and we considered these relationships in developing the proposed regulation. For

this reason, we proposed that the contractor individually identify discounts, rebates or applicable credits on the bills and invoices, but did not propose that the contractor identify the source of the discount, rebate or other applicable credit on the invoice.

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

Although this final rule does not require the reporting of confidential business information on bills and invoices, it does require that the contractor maintain records and source documents in support of the costs and discounts, rebates and other applicable credits included on bills and invoices to the school food authority and make them available to the school food authority, State agency and Department upon request. This record retention requirement is no different from the existing requirements found in Department regulations at §§ 3016.36(i)(10) and 3019.48(d). Contractors have always been required to maintain source documents in support of the costs charged to school food authorities. The intent of the provisions at §§ 210.21(f)(1)(iv), 215.14a(d)(1)(iv) and 220.16(e)(1)(iv) and the record retention requirements in the Department's regulations is to provide sufficient information to permit a school food authority to determine the costs billed by its contractors that can be paid from the nonprofit school food service account, and to permit a subsequent review of the contractor's source documents to verify that the costs, discounts, rebates, and other

applicable credits were properly reported under the terms of the contract.

To eliminate the possibility that readers could misinterpret this requirement, this final rule amends §§ 210.21(f)(1)(iv), 215.14a(d)(1)(iv) and 220.16(e)(1)(iv) to clarify that contractors are only required to identify the amount of each discount, rebate or applicable credit on the bill or invoice and whether the amount is a discount, rebate, or in the case of some other form of applicable credit, the nature of that credit.

#### Timing

Several commenters expressed concerns with the timing of the reporting required of contractors to identify discounts, rebates and other applicable credits on all bills and invoices sent to the school food authority. Presumably, this would occur on a monthly basis. In commenting on the timing, one commenter suggested requiring potential contractors to include this information up front, by bidding prices as if the discount, rebate or other applicable credit had already been earned, with a subsequent reconciliation at the end of the contract.

We considered the option of requiring prices to be bid less discounts, rebates and other applicable credits. However, we do not believe this will improve full and open competition nor will such a requirement maintain the integrity of the nonprofit school food service account given the current state of school food authority procurements, as this information may not always be available to the contractor at the time of bidding.

However, since FNS is encouraging State agencies to take a more active role in school food authority procurements, this final rule amends §§ 210.21(f)(1)(iv), 215.14a(d)(1)(iv) and 220.16(e)(1)(iv) to permit State agencies to approve reporting on other than a monthly basis, but not less frequently than annually. A State agency may choose to establish reporting timeframes on an individual contract basis or on a Statewide basis.

Other commenters on the issue of timing addressed the reporting of discounts, rebates and other applicable credits that result from contract activity, but are not earned or received by the contractor until after the contract has ended. While some discounts, rebates, and other applicable credits will be known to the contractor when bills are issued to the school food authority, others, particularly volume discounts, may not be known until some point in the future. For example, a volume purchase discount is earned when sales of a particular item reach an established

target. The contractor may not reach the target sales volume until after the school food authority's contract has ended, even though the purchases by the school contributed to reaching the target volume. This could occur when the timing of the school food authority's contract does not coincide with the timing of the volume discount earning period, or even when the timing of the contract and the volume discount earning period is the same but the contractor does not receive the benefit of a volume discount, rebate or other applicable credit until after the school food authority's contract has concluded. The method for providing the discount, rebate, or other applicable credit amount in this situation depends on whether the contractor and the school food authority maintain an on-going, uninterrupted, contractual relationship, *i.e.*, a subsequent or renewal contract is in place. When the contractor and the school food authority's contractual relationship is uninterrupted, the contractor can include the discount, rebate, or other applicable credit in the next reporting period after it is received. For those situations in which the contractor and the school food authority do not maintain an uninterrupted contractual relationship, the amount of the discount, rebate or applicable credit must be provided to the school food authority once these amounts are known to the contractor. Depending upon the school food authority's financial management practices, the school food authority may need the contractor to identify the period in which the discount, rebate, or other applicable credit was earned so that it can adjust its accounting records accordingly. In such cases, the contractor would need to provide sufficient information for the school food authority to identify the appropriate accounting period requiring adjustment.

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

#### Identification of Allowable and Unallowable Costs on Invoices

The provision of the proposed rule requiring contractors to identify allowable and unallowable costs on invoices was added to provide school food authorities with the information they need to determine what may be paid out of the nonprofit school food

service account. We considered four alternatives when developing this provision of the proposed rule, including: (1) Maintaining the status quo of not requiring specific documentation; (2) requiring that contractors provide source documentation to school food authorities for all costs charged; (3) requiring that contractors have an annual audit for each cost contract with a school food authority to determine allowable and unallowable costs; or (4) requiring that contractors include only allowable costs on invoices.

Maintaining the status quo was rejected because OIG audits and investigations indicated that nonprofit school food service account funds have been expended for unallowable costs because the school food authority had insufficient information to identify unallowable costs included on invoices. The requirement that contractors provide source documentation for all costs charged was rejected because it would be excessively burdensome on contractors to provide this information. Similarly, an annual audit requirement was rejected because it would be both burdensome and cost prohibitive for contractors to incur annual audit costs for each of its cost reimbursable contracts with school food authorities. Finally, the fourth alternative of requiring that contractors include only allowable costs on invoices was rejected in developing the proposed rule because it would interfere with the school food authority's right to enter into contracts that contained costs that were unallowable nonprofit school food service account expenditures, but nevertheless represented costs the school food authority was willing to fund from other sources.

However, FNS has now reconsidered this fourth alternative (requiring that contractors include only allowable costs on invoices) because a school food authority can elect to contract only for allowable costs. If, in our previous example, the janitorial supplies contract was cost reimbursable instead of fixed price, pursuant to the provisions of this final rule, the contractor would appropriately identify all of the janitorial supplies sold to the school food authority as allowable costs on its monthly invoice. The contractor's identification of allowable and unallowable costs on the invoice does not mean that the school food authority can fund the entire cost of its janitorial supplies contract from its nonprofit school food service account. Because the school food authority, not the contractor, is ultimately responsible for ensuring that expenditures from the

nonprofit school food service account are allowable costs as determined in accordance with the applicable OMB cost circular, the school food authority would still be required to fund only its share of the allowable and allocable janitorial supply costs from its nonprofit school food service account.

As a result of this reconsideration, this final rule amends §§ 210.21(f)(1)(ii), 215.14a(d)(1)(ii) and 220.16(e)(1)(ii) to allow school food authorities to choose between two cost reporting provisions for solicitation documents and contracts. The first cost reporting provision finalizes the provision contained in the proposed rulemaking that contractors identify allowable and unallowable costs on billing documents. The second cost reporting provision requires contractors to exclude unallowable costs from billing documents and to certify that only allowable costs are submitted for payment and that records have been established that maintain the visibility of unallowable costs, including directly associated costs, in a manner suitable for contract cost determination and verification. Regardless of the cost provision chosen, contractors would still be required to report discounts, rebates and other applicable credits, and school food authorities would still be required to limit expenditures of nonprofit school food service account funds to net allowable costs.

#### Applicability of the OMB Cost Circulars to School Food Authority Contracts

Two comments were received on the proposed rule's provision that allowable costs be identified by the contractor in accordance with applicable OMB Cost Circulars (A-87 Cost Principles for State, Local Governments and Indian Tribal Governments and A-122 Cost Principles of Non-profit Organizations). These commenters asserted that the cost principles contained within the Federal Acquisition Regulations (FAR) should be used to determine allowable costs that result from contracts with commercial organizations rather than cost principles contained in the OMB Cost Circulars applicable to public and private nonprofit school food authorities.

The governing Department regulations (§§ 3016.22(b) and 3019.27) make clear that for each type of organization there is a set of Federal principles for determining allowable costs. The determination is made based on the type of recipient incurring the costs under the Federal program. Since commercial organizations are not eligible recipients of the school nutrition funds provided by FNS, their only role can be that of a

contractor to an eligible recipient (*i.e.*, a school food authority). As an eligible recipient of federal funds, a public school food authority must use OMB Circular A-87 to determine whether costs are allowable, while a private nonprofit school food authority (*e.g.*, in the case of a parochial school) must use OMB Circular A-122 to make this determination. Only when a commercial organization is contracting directly with the Federal government would the FAR (48 CFR part 31, Subpart 31.2) and its applicable Cost Accounting Standards (48 CFR 9901.306) be used to determine allowable costs.

Ultimately, the school food authority, not its contractor, is responsible for ensuring that expenditures from the nonprofit school food service account are allowable costs as determined in accordance with the applicable OMB cost circular. This is not a new requirement. School food authorities have been subject to the OMB cost circulars since November 10, 1981, when the Department issued 7 CFR 3015, Uniform Federal Assistance Regulations (46 FR 55640). Further, limitations on claiming only allowable costs have been in place for school food authorities since at least January 1, 1967 (32 FR 33).

A related issue concerning the applicability of the FAR to school food service contracts is the recovery of administrative cost overhead charges from retained discounts and rebates. In this case, one commenter asserted that contractors should be allowed to retain rebates and discounts to cover those corporate indirect costs that are not included in the fixed fee component of their cost reimbursable contracts, and that such actions were permissible for contractors subject to the FAR at 48 CFR part 31, Subpart 31.2. The commenter further asserted that FNS should allow such practices. We disagree. As discussed above, the FAR does not apply to any school food service contracts. Therefore, these suggested practices are not adopted in this final rule.

The same commenter also asserted that even if the FAR did not apply to contracts with school food authorities, the OMB cost circulars would allow the contractor to retain the discounts, rebates, and other applicable credits earned on the cost component of its contracts in order to offset its administrative costs charged through its fixed fee. Again, the Department disagrees. The effect of the commenter's position could unnecessarily increase nonprofit school food service expenditures. A cost reimbursable with fixed fee contract consists of the cost

component and the fixed fee component. The rebates, discounts and other applicable credits subject to the rulemaking are earned through the cost component of the contract, not the contractor's fixed fee component.

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

This final rulemaking does not affect how a contractor establishes its full administrative costs in its fixed fee since this is a business decision. However, the principle of a fixed price is that the price is fixed in the manner and for the period of time specified in the contract. We are not aware of any cost principle or procurement provision that permits a contractor to increase the fixed price component of a contract without disclosure of the change and the agreement of the other party to the contract. When a potential contractor submits a fixed price offer, is awarded a contract based on the price, and then contractually agrees to that price, the contractor may not violate the terms of its contract by increasing that price by retaining undisclosed rebates, discounts or other applicable credits.

This confirms one of the key points underlying the issuance of the proposed rule as well as this final rule, which is that school food authorities must clearly specify how costs must be billed to the school food authority in order for a potential contractor to determine which costs should be included in its fixed fee.

In order to clarify what can be included in fixed fees, the newly added definition of "fixed fee" at §§ 210.2, 215.2 and 220.2 specifies that the contractor's direct and indirect administrative costs and profit allocable to the contract may be included. A potential contractor is free to determine what portion of its overhead and indirect administrative costs is allocable to a contract in its fixed fee component. However, if a potential contractor chooses to exclude such costs from the fixed fee component, attempting to recover these costs by retaining discounts, rebates and other applicable credits earned through the cost reimbursable portion of the contract is

unallowable. If a school food authority permits the contractor to retain these discounts, rebates, and applicable credits the school food authority is responsible for ensuring that the amount that these discounts, rebates, and credits represent is returned the nonprofit school food service account.

#### *Contractor Administrative Costs*

One commenter asserted that contractors should have the option of charging the school food authority a fee for late payments. The commenter did not explain why he believed such charges were prohibited or how the proposed rule would interfere in a contractor's right to include a provision requiring payment of late fees in a contract with a school food authority. There is no provision in this final rule or elsewhere in any of the Child Nutrition Program or Department regulations that would prevent a contractor from negotiating an agreement that imposes a fee when the school food authority fails to pay its debts in a timely manner. In the past, FNS has affirmed the right of contractors to request and enforce provisions addressing the imposition of late payment fees in contracts, as long as such provisions do not conflict with applicable State and local procurement laws and regulations. However, we also continue to maintain the position that the school food authority may not use its nonprofit school food service account funds to pay the cost of such fees. These fees represent fines and penalties, which are unallowable costs under the applicable OMB cost circulars. In keeping with the provisions of this final rulemaking, the contractor would be required to identify any late payment charge on its billing documents as an unallowable cost (*i.e.*, a cost that cannot be funded from the nonprofit school food service account).

Two commenters requested clarification that any added costs resulting from implementing this final rule would be allowable charges to school food authorities. Neither of the commenters specifically identified where they would incur increased costs or the amount of any increase, but we would expect any increased costs to be incurred in the allocation and records maintenance of discounts, rebates, and other applicable credits to school food authorities, and/or in the identification and reporting of allowable and unallowable costs. Contractors already track the costs that are billed to school food authorities and have accounting and billing systems in place for school food authority contracts. Further, under Generally Accepted Accounting

Principles and good business practices, these contractors maintain systems to track and report discounts and rebates. Any additional cost incurred by contractors for implementing the provisions of this regulation is an element of a company's administrative expenses and is allocable and may be included in the fixed fee component of a cost reimbursable contract. The decision as to whether to record the expense as an overhead, accounting or management cost is a corporate financial management decision.

#### *State Agency Review of Procurement Documents*

Sections 210.16(a)(10), 210.19(a)(6), 215.14a(c)(1) and 220.7(d)(1)(ix) of the proposed rule required State agency review and approval of contracts and contract amendments between school food authorities and food service management companies prior to each contract's execution to ensure that such contracts comply with all program requirements. If a school food authority fails to make changes required by the State agency, then the proposed rule provided at §§ 210.19(a)(2), 215.a(c)(3) and 220.16(c)(3) that all costs associated with such contracts would be unallowable charges to the nonprofit school food service account.

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

Under current regulations, State agencies generally do not review school food authority contracts until after the contracts have been executed (*i.e.*, signed by the school food authority and the contractor). Unfortunately, when the State agency finds problems with the terms of an already executed contract, it may be too late to remedy the problems for the current contract, except when State or local laws and procedures permit contract nullification. Since the school food authority is bound to fulfill its contract terms, in the most serious cases, the State agency's only recourse is to disallow all costs resulting from the contract. In this case, school food authorities may not use the nonprofit school food service account to pay these costs.

One State agency suggested that a school food authority's compliance with procurement requirements be included in the Single Audit. Since an audit is conducted on a prior period, it would be



too late to correct any deficiencies that are found. Generally the only option to respond to audit deficiencies is to disallow the costs associated with noncompliance and seek corrective action to prevent recurrence of the problem. Cost disallowances can seriously undermine the financial integrity of the school's nutrition programs for children.

FNS' intent in moving the State agency review of food service management company contracts from after execution to before execution is to provide a means for identifying and correcting problems in contracts before they are signed. This approach helps ensure that school food authorities are not routinely subject to cost disallowances.

Another State agency expressed concern that the proposed rule at § 210.19(a)(6) would require a State agency to review previously approved prototype food service management company contracts even when no changes had been made to the contract. This was not our intent, nor do we believe this will occur. This final rulemaking requires school food authorities using a State agency pre-approved prototype food service management company contract to obtain prior written approval of the State agency only when changes are made to that contract (§§ 210.16(a)(10) and 220.7(d)(1)(ix)). In response to this comment, we have added a corresponding sentence at § 210.19(a)(6) of this final rule to clarify that when a school food authority is using a State agency prototype food service management company contract, the State agency is only required to review the changes made to that prototype contract.

A third State agency, which from the description of its current actions already has an extensive preapproval process for food service management company contracts, expressed concern that the proposed change would impose an additional review on top of the review it already performs. FNS will work with individual State agencies to ensure that any changes resulting from implementing this final rulemaking do not duplicate or diminish a State agency's current approval process. Two State agencies indicated that pre-execution reviews of food service management company contracts are already occurring; four additional commenters supported the proposal.

One commenter suggested nonsubstantive rewording of certain sentences at § 210.16(a)(9) and (a)(10). We agree that the commenter's proposed changes make the provisions easier to

read and have amended § 210.16(a)(9) and (a)(10) and the corresponding provisions at § 220.7(d)(1)(viii) and (d)(1)(ix) of this final rule accordingly. We also added language to § 210.19(a)(6) to clarify that State agency review of contracts includes review of the supporting documentation to the contract, including the request for proposal or invitation for bid.

Other commenters requested that the regulation permit the State agency flexibility in establishing due dates for school food authority procurement documents. Two commenters requested more specific regulatory authority to withhold payments when school food authorities fail to comply with a request for timely submission of required documents.

Currently, sufficient regulatory authority exists to permit State agencies to establish reasonable due dates consistent with their resource and work load limitations. However, this final rule amends §§ 210.16(a)(10), 210.19(a)(6) and 220.7(d)(1)(ix) to permit State agencies to establish due dates for submission of the documents needed for this approval. Failure of a school food authority to respond to these due dates would result in regulatory noncompliance, and the school food authority's failure to correct this deficiency could result in the withholding of reimbursement pursuant to current §§ 210.22 and 220.18.

#### *Miscellaneous Comments*

Several commenters expressed opinions on the provision in the proposed rule at § 210.16(b)(1) that permits a food service management company to submit the 21-day menu and requires compliance with the menu for the first 21 days of food service operations. FNS was not proposing any changes to this provision, but instead used the opportunity of the proposed rulemaking to restructure a cumbersome sentence.

One commenter questioned FNS' legal authority to issue the proposed regulation. The Secretary's authority to issue regulations is found at 42 U.S.C. 1779 which authorizes the Secretary to prescribe such regulations as deemed necessary to carry out the provisions of the Child Nutrition Act of 1966 and the Richard B. Russell National School Lunch Act.

One commenter suggested clarifying that FNS regulations implement applicable OMB circulars at § 210.21(a) and the deletion of the last sentence at § 210.21(c). We agree and have amended § 210.21(a) and (c) as well as the corresponding provisions at

§§ 215.14a(a), 215.14(a)(c), 220.16(a) and 220.16(c) accordingly.

Another commenter requested clarification as to whether Department regulation 7 CFR part 3015 still applies to FNS's school nutrition programs. While the majority of the Department's requirements that apply to the school nutrition programs have been moved from 7 CFR part 3015 into 7 CFR parts 3106 and 3019, some requirements, particularly those affecting the award of discretionary grants, acknowledgment on audio visual materials and procedures for prior approval of costs, still remain in 7 CFR part 3015.

One commenter requested clarification that the prohibition at § 3016.60(b) that contractors may not develop or draft specifications, requirements, statements of work, invitations for bid, requests for proposal, contract terms and conditions or other document for use by a school food authority would not apply to winning bidders negotiating contract terms since conducting a procurement does not include post-procurement activities. While 7 CFR part 3016 was not the subject of the proposed rulemaking, it is important to correct the commenter's misunderstanding of what constitutes the procurement process. The procurement process includes all phases of the process from the initial determination that goods and services are needed until the conclusion of the record retention period following the termination of the contract period. While negotiating contract terms is acceptable, potential contractors are not permitted to draft contract terms and conditions. This position is consistent with §§ 3016.36(b) and 3016.60(b), and with the direction provided in Conference Report 105-786 accompanying the William F. Goodling Child Nutrition Reauthorization Act of 1998 (Pub. L. 105-336).

This same commenter also expressed concerns that under the Federalism principles it is inappropriate for FNS to assist State agencies in the development and drafting of procurement documents. Responding to requests for assistance from State agencies does not conflict with the principles of Federalism, nor does providing assistance to State agencies in their development of procurement documents run counter to the report language cited. It is unreasonable to expect State agencies to develop appropriate procurement materials without access to FNS's resources and expertise concerning federal procurement rules.

*Ethics in Long Term Beverage and Food Service Management Company Procurements*

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

Three commenters indicated their opinions that FNS needs to undertake additional efforts in this area. Commenters also supported the need for additional efforts by FNS to address long term beverage contracting issues. Some of these commenters were specific about ethical issues in the procurement of long term beverage and food service management contracts, while others addressed the ethics issue on a broader scale. One commenter requested that the final regulations prohibit contractors from offering incentive payments or providing payments in advance of contract execution since such payments could subvert full and open competition. We do not disagree with the commenter that an inducement to contract conflicts with full and open competition. However, because we did not propose to issue regulations addressing ethics at this time, it would be inappropriate for us to do so in a final rulemaking. Pursuant to the Department regulations, school food authorities are currently required to have a written code of conduct that prohibits unethical actions in the procurement process.

Another commenter recommended that FNS require State agencies and school food authorities to obtain written financial interest statements from potential consultants which would require these consultants to disclose possible conflicts of interest before engaging in consulting and technical assistance efforts. Again, while we agree that such statements represent good business practice, it would be inappropriate at this time to issue final regulations requiring such statements.

Given the comments received on the issue of ethics in contracting, FNS has determined it is appropriate to include a reference to its existing ethics and integrity requirements at §§ 210.21(c), 215.14a and 220.16(c). FNS will continue to monitor procurement ethics and integrity as this final rule is implemented and will evaluate if

additional actions are needed to address these issues.

### III. Implementation

FNS also received comments on implementation timeframes for a final rulemaking. Some of the commenters requested a moratorium on implementation for existing contracts between school food authorities and food service management companies until after all contract renewals had been completed. These commenters viewed the one-year term of a food service management company contract with up to four additional one-year renewals as a single contract. That is not correct. Food service management company contracts are one year in duration. The decision to renew the contract is an affirmative decision by both parties. Generally each renewal period is accompanied by some change in the contract terms, usually related to the change in FNS' school meal reimbursement rates. We are also aware that some contracts contain a provision that results in renewal unless notification of nonrenewal is provided. This type of provision does not create a multi-year contract.

One commenter requested implementation over a period of time to permit an orderly process for school food authorities to develop appropriate procurement documents and provide sufficient time for State agencies to review those documents.

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

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

(1) The regulations are applicable for all new solicitations issued on or after the effective date of this final rule.

(2) For those solicitations for contracts issued prior to the effective date of this final rule:

a. School food authorities and State agencies with contracts with a term of 12 months or fewer remaining are exempt from applying the provisions of this rulemaking to those contracts;

b. With State agency approval, school food authorities with contracts that have annual renewal provisions may delay implementation until expiration of the current contract plus one 12-month renewal period; and

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

The annual term of most school food authority food service management company contracts mirrors the July 1–June 30 school year. This means that a school food authority that entered into the first year of its contract effective for the July 1, 2007–June 30, 2008 school year may, with State agency approval, renew the contract for the July 1, 2008–June 30, 2009 school year, but must conduct a new procurement that meets the requirements of these regulations for the school year that begins on July 1, 2009. State agencies are free to establish shorter timeframes for implementation or may require some school food authorities to implement the requirements sooner than others. However, in no case may a school food authority be permitted to delay implementation beyond the timeframes specified above.

### IV. Technical Assistance

Many commenters, particularly State administering agencies and the School Nutrition Association, requested training and technical assistance on this final rule as well as on procurement requirements and allowable costs in general. The Department agrees and will, within current resource constraints, do its best to provide training and technical assistance on this rule after publication. We will also continue to issue guidance as the need arises. However, neither the Department's planned training nor its guidance will address specific State and local procurement requirements. Public school food authorities must follow their own applicable State and local procurement procedures and will only revert to Federal requirements when applicable State and local requirements

are less restrictive. FNS is not the appropriate source for interpreting State and local requirements or for providing training on these requirements. We encourage State administering agencies, school food authorities and industry partners to look for these resources within their own State and local jurisdictions.

#### V. Procedural Matters

##### *Executive Order 12866*

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

##### *Regulatory Impact Analysis*

###### Need for Action

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

###### Benefits

School food authorities will benefit from the provisions of this rule because they will better understand their responsibilities for conducting proper procurements and consequences for failing to conduct proper procurements. State agencies will have the authority to review school food authority procurement documents and procedures to identify deficiencies and obtain corrective action, thereby minimizing the potential for the misuse of program funds. Competition will be enhanced because potential contractors will be provided with more specific information that will allow them to prepare more appropriate and competitive responses to school food authority solicitations.

###### Costs

Any increases in costs resulting from this final rule are expected to result from the contractor's allocation and records maintenance of rebates, discounts, and other applicable credits to school food authorities and the identification and reporting of allowable and unallowable costs. However, contractors already have accounting, reporting and records maintenance systems in place to track and report the costs that are billed to school food authorities. Further, under generally accepted accounting principles and good business practices, these contractors maintain systems to track

and report rebates and discounts. For these reasons, it is not expected that contractors will incur a significant increase in costs due to these requirements. However, any additional costs incurred by contractors for implementing the provisions of these regulations would be part of the contractor's administrative expenses and could be included in the fixed fee component of a cost reimbursable contract.

##### *Regulatory Flexibility Act*

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

##### *Unfunded Mandates Reform Act*

Title II of the Unfunded Mandates Reform Act of 1995 (UMRA), Public Law 104–4, establishes requirements for Federal agencies to assess the effects of their regulatory actions on State, local, and tribal governments and the private sector. Under Section 202 of the UMRA, the Department generally must prepare a written statement, including a cost/benefit analysis, for proposed and final rules with Federal mandates that may result in expenditures to State, local, or tribal governments in the aggregate, or to the private sector, of \$100 million or more in any one year. When such a statement is needed for a rule, section 205 of the UMRA generally requires the Department to identify and consider a reasonable number of regulatory alternatives and adopt the least costly, more cost-effective or least burdensome

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

##### *Executive Order 12372*

The National School Lunch Program, Special Milk Program and School Breakfast Program are listed in the Catalog of Federal Domestic Assistance under No. 10.555, 10.556, and 10.553, respectively. For the reasons set forth in the final rule in 7 CFR part 3015, Subpart V and related Notice published at 48 FR 29114, June 24, 1983, these programs are included in the scope of Executive Order 12372, which requires intergovernmental consultation with State and local officials.

##### *Executive Order 13132*

Executive Order 13132 requires Federal agencies to consider the impact of their regulatory actions on State and local governments. Where such actions have federalism implications, agencies are directed to provide a statement for inclusion in the preamble to the regulations describing the agency's considerations in terms of the three categories called for under section (6)(b)(2)(B) of Executive Order 13132. FNS has considered the impact of this rule on State and local governments and has determined that this rule does not have Federalism implications. This rule does not impose substantial or direct compliance costs on State and local governments. Therefore, under Section 6(b) of the Executive Order, a federalism summary impact statement is not required.

##### *Executive Order 12988*

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

##### *Civil Rights Impact Analysis*

Under Department Regulation 4300–4, Civil Rights Impact Analysis, FNS has

reviewed this final rule to identify and address any major civil rights impacts the final rule might have on minorities, women, and persons with disabilities. After a careful review of the rule's intent and provisions, FNS has determined that this rule would not in any way limit or reduce participants' ability to participate in the Child Nutrition Programs on the basis of an individual's or group's race, color, national origin, sex, age or disability. FNS found no factors that would negatively and disproportionately affect any group of individuals.

*Paperwork Reduction Act*

FNS is revising the regulations governing procedures related to the procurement of goods and services in the National School Lunch Program, School Breakfast Program and Special Milk Program to remedy deficiencies identified in audits and program reviews. This final rule makes changes in a school food authority's responsibilities for proper procurement procedures and contracts, limits a school food authority's use of nonprofit school food service account funds to

costs resulting from proper procurements and contracts, and clarifies a State agency's responsibility to review and approve school food authority procurement procedures and contracts.

As a result, we are amending § 210.16(a) by adding two requirements for school food authorities that contract with food service management companies to manage their food service operations. First, § 210.16(a)(9) requires school food authorities to obtain written approval of invitations for bids and requests for proposals when required by the State agency and to incorporate all State agency changes before issuance. Second, § 210.16(a)(10) requires the school food authority to ensure that the State agency has reviewed and approved contract terms and to incorporate all changes before any contract or amendment to an existing contract is executed. We are also amending § 210.19(a)(6) to specify that State agencies must review contracts, including amendments, and all supporting documentation, before execution of the contract. Current regulations require State agencies to

annually review each contract to ensure compliance, which is usually done after the contract has been executed. Since the current requirement does not specify the timing of the review, additional time will be needed to review the contract and its related documents. As outlined below, these sections contain specific public reporting and recordkeeping requirements that require clearance under the Paperwork Reduction Act of 1995. Respondents to this collection are State agencies and school food authorities that employ a food service management company in the operation of their nonprofit school food service.

Burden associated with this rule has been approved by OMB under OMB Control Number 0584-0544. State agencies and school food authorities that operate the School Breakfast and Special Milk Programs also operate the National School Lunch Program; therefore, the burden will be merged into OMB #0584-0006, National School Lunch Program, once this rule becomes effective.

*Title:* Procurement Requirements for the National School Lunch

Title/section & collection description	Annual number of respondents	Frequency of response	Average burden per response (hours)	Estimated annual burden hours
<b>Recordkeeping:</b>				
210.19(a)(6)—State agency review and approve contracts prior to execution .....	57	21.78	0.167	207.324
Current Approved under #0584-0006 New Burden Requirements .....	57	30	.4	684
Difference .....				476.676
<b>Reporting:</b>				
210.16(a)(9) & (10)—School food authority provide procurement documents to State agency for approval. Current Approved under #0584-0006 .....	1,648	1	.25	412
New Burden Requirements .....	1,648	1	1.5	2,472
Difference .....				2,060
<b>Total Burden Requested .....</b>				<b>2,537</b>

*E-Government Act Compliance*

FNS is committed to complying with the E-Government Act, to promote the use of the Internet and other information technologies to provide increased opportunities for citizen access to Government information and services, and for other purposes.

**List of Subjects**

*7 CFR Part 210*

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

*7 CFR Part 215*

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

*7 CFR Part 220*

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

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

**PART 210—NATIONAL SCHOOL LUNCH PROGRAM**

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

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

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

**§ 210.2 Definitions.**

\* \* \* \* \*

*Applicable credits* shall have the meaning established in Office of Management and Budget Circulars A-87, C(4) and A-122, Attachment A, A(5),

respectively. For availability of OMB circulars referenced in this definition see 5 CFR 1310.3.

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

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

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

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

- 3. In § 210.16:
  - a. Amend paragraph (a)(7) by removing the word "and" at the end of the paragraph;
  - b. Amend paragraph (a)(8) by removing the period at the end of the paragraph and adding a semicolon in its place;
  - c. Add paragraphs (a)(9) and (a)(10); and
  - d. Amend paragraph (b)(1) by removing the second sentence and adding a new sentence in its place.

The additions read as follows:

**§ 210.16 Food service management companies.**

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

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

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

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

- 4. In § 210.19:
  - a. Amend paragraph (a)(2) by adding two new sentences between sentences two and three; and
  - b. Amend paragraph (a)(6) by removing the first sentence and adding four new sentences in its place.

The additions read as follows:

**§ 210.19 Additional responsibilities.**

(a) \* \* \* (2) \* \* \* All costs resulting from contracts that do not meet the requirements of this part are unallowable nonprofit school food service account expenses. When the school food authority fails to incorporate State agency required changes to solicitation or contract documents, all costs resulting from the subsequent contract award are unallowable charges to the nonprofit school food service account. \* \* \*

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

submission of the contract or contract amendment documents. \* \* \*

- 5. In § 210.21:
  - a. Revise paragraph (a);
  - b. Revise paragraph (c); and
  - c. Add a new paragraph (f).

The revisions and addition read as follows:

**§ 210.21 Procurement.**

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

(c) *Procedures.* The State agency may elect to follow either the State laws, policies and procedures as authorized by §§ 3016.36(a) and 3016.37(a) of this title, or the procurement standards for other governmental grantees and all governmental subgrantees in accordance with § 3016.36(b) through (i) of this title. Regardless of the option selected, States must ensure that all contracts include any clauses required by Federal statutes and executive orders and that the requirements of § 3016.60(b) and (c) of this title are followed. A school food authority may use its own procurement procedures which reflect applicable State and local laws and regulations, provided that procurements made with nonprofit school food service account funds adhere to the standards set forth in this part and §§ 3016.36(b) through 3019.48 of this title, as applicable, and in the applicable Office of Management and Budget Circulars. School food authority procedures must include a written code of standards of conduct meeting the minimum standards of § 3016.36(b)(3) or § 3019.42 of this title, as applicable.

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

documents reflect applicable procurement and contract requirements and the requirements of this part.

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

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

\* \* \* \* \*

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

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

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

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

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

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

approved by the State agency, the school food authority may permit the contractor to report this information on a less frequent basis than monthly, but no less frequently than annually;

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

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

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

**§ 210.24 [Amended]**

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

**PART 215—SPECIAL MILK PROGRAM**

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

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

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

**§ 215.2 Definitions.**

\* \* \* \* \*

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

\* \* \* \* \*

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

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

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

\* \* \* \* \*

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

\* \* \* \* \*

- 3. In § 215.14a;
- a. Revise paragraph (a);
- b. Revise paragraph (c); and
- c. Add a new paragraph (d).

The revisions and addition read as follows:

**§ 215.14a Procurement standards.**

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

\* \* \* \* \*

(c) *Procedures.* The State agency may elect to follow either the State laws, policies and procedures as authorized by §§ 3016.36(a) and 3016.37(a) of this title, or the procurement standards for other governmental grantees and all governmental subgrantees in accordance with § 3016.36(b) through (i) of this title. Regardless of the option selected, States must ensure that all contracts include any clauses required by Federal statutes and executive orders and that the requirements of § 3016.60(b) and (c) of this title are followed. The school food authority or child care institution may use its own procurement procedures which reflect applicable State or local laws and regulations, provided that procurements made with nonprofit school food service account funds adhere to the standards set forth in this part and §§ 3016.36(b) through 3016.36(i), 3016.60 and §§ 3019.40 through 3019.48 of this title, as applicable, and in the applicable Office of Management and Budget Circulars. School food authority procedures must include a written code of standards of conduct meeting the minimum standards of § 3016.36(b)(3) or § 3019.42 of this title, as applicable.

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

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

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

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

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

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

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

contract cost determination and verification;

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

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

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

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

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

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

**§ 215.15 Withholding payments.**

In accordance with Departmental regulations at § 3016.43 and § 3019.62 of this title, the State agency shall withhold Program payments in whole or in part, to any school food authority which has failed to comply with the provisions of this part. Program payments shall be withheld until the school food authority takes corrective action satisfactory to the State agency, or gives evidence that such corrective actions will be taken, or until the State agency terminates the grant in accordance with § 215.16. Subsequent to the State agency's acceptance of the corrective actions, payments will be released for any milk served in accordance with the provisions of this

part during the period the payments were withheld.

**PART 220—SCHOOL BREAKFAST PROGRAM**

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

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

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

**§ 220.2 Definitions.**

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

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

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

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

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

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

**§ 220.7 Requirements for participation.**

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

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

- (i) Adhere to the procurement standards specified in § 220.16 when contracting with the food service management company;
- (ii) Ensure that the food service operation is in conformance with the school food authority's agreement under the Program;
- (iii) Monitor the food service operation through periodic on-site visits;
- (iv) Retain control of the quality, extent, and general nature of its food service, and the prices to be charged the children for meals;
- (v) Retain signature authority on the State agency-school food authority agreement, free and reduced price policy statement and claims;
- (vi) Ensure that all federally donated foods received by the school food authority and made available to the food service management company accrue only to the benefit of the school food authority's nonprofit school food service and are fully utilized therein;
- (vii) Maintain applicable health certification and assure that all State and local regulations are being met by a food service management company preparing or serving meals at a school food authority facility;
- (viii) Obtain written approval of invitations for bids and requests for proposals before their issuance when required by the State agency. The school food authority must incorporate all State agency required changes to its solicitation documents before issuing those documents; and
- (ix) Ensure that the State agency has reviewed and approved the contract terms and the school food authority has incorporated all State agency required changes into the contract or amendment before any contract or amendment to an existing food service management company contract is executed. Any changes made by the school food authority or a food service management company to a State agency pre-approved prototype contract or State agency approved contract term must be approved in writing by the State agency before the contract is executed. When requested, the school food authority must submit all procurement documents, including responses submitted by potential contractors, to the State agency, by the due date established by the State agency.

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

- (i) The invitation to bid or request for proposal contains a 21-day cycle menu developed in accordance with the provisions of § 220.8, to be used as a standard for the purpose of basing bids or estimating average cost per meal. A school food authority with no capability to prepare a cycle menu may, with State agency approval, require that each food service management company include a 21-day cycle menu, developed in accordance with the provisions of § 220.8, with its bid or proposal. The food service management company must adhere to the cycle for the first 21 days of meal service. Changes thereafter may be made with the approval of the school food authority; and
  - (ii) Any invitation to bid or request for proposal indicate that nonperformance subjects the food service management company to specified sanctions in instances where the food service management company violates or breaches contract terms. The school food authority shall indicate these sanctions in accordance with the procurement provisions stated in § 220.16.
- (3) Contracts that permit all income and expenses to accrue to the food service management company and "cost-plus-a-percentage-of-cost" and "cost-plus-a-percentage-of-income" contracts are prohibited. Contracts that provide for fixed fees such as those that provide for management fees established on a per meal basis are allowed. Contractual agreements with food service management companies shall include provisions which ensure that the requirements of this section are met. Such agreements shall also include the following requirements:
- (i) The food service management company shall maintain such records as the school food authority will need to support its Claim for Reimbursement under this part, and shall, at a minimum, report claim information to the school food authority promptly at the end of each month. Such records shall be made available to the school food authority, upon request, and shall be available for a period of 3 years from the date of the submission of the final Financial Status Report, for inspection and audit by representatives of the State agency, of the Department, and of the Government Accountability Office at any reasonable time and place. If audit findings have not been resolved, the records shall be retained beyond the three-year period (as long as required for

the resolution of the issues raised by the audit);

- (ii) The food service management company shall have State or local health certification for any facility outside the school in which it proposes to prepare meals and the food service management company shall maintain this health certification for the duration of the contract; and
  - (iii) No payment is to be made for meals that are spoiled or unwholesome at time of delivery, do not meet detailed specifications as developed by the school food authority for each food component specified in § 220.8, or do not otherwise meet the requirements of the contract. Specifications shall cover items such as grade, purchase units, style, condition, weight, ingredients, formulations, and delivery time.
- (4) The contract between a school food authority and food service management company shall be of a duration of no longer than 1 year and options for the yearly renewal of the contract shall not exceed 4 additional years. All contracts shall include a termination clause whereby either party may cancel for cause with 60-day notification.

\* \* \* \* \*

- 4. In § 220.16,
- a. Revise paragraphs (a) and (c); and
- b. Add a new paragraph (e).

The revisions and addition read as follows:

**§ 220.16 Procurement standards.**

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

\* \* \* \* \*

(c) *Procedures.* The State agency may elect to follow either the State laws, policies and procedures as authorized by §§ 3016.36(a) and 3016.37(a) of this title, or the procurement standards for other governmental grantees and all governmental subgrantees in accordance with § 3016.36(b) through (i) of this title. Regardless of the option selected, States must ensure that all contracts include any clauses required by Federal statutes and executive orders and that the requirements of § 3016.60(b) and (c) of this title are followed. The school food authority may use its own procurement procedures which reflect applicable State and local laws and regulations, provided that procurements made with



nonprofit school food service account funds adhere to the standards set forth in this part and §§ 3016.36(b) through 3016.36(i), 3016.60 and §§ 3019.40 through 3019.48 of this title, as applicable, and the applicable Office of Management and Budget Circulars. School food authority procedures must include a written code of standards of conduct meeting the minimum standards of § 3016.36(b)(3) or § 3019.42 of this title, as applicable.

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

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

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

\* \* \* \* \*

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

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

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

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

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

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

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

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

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

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

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

**§ 220.18 Withholding payments.**

In accordance with Departmental regulations at § 3016.43 and § 3019.62 of this title, the State agency shall withhold Program payments, in whole

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

Dated: October 4, 2007.

**Nancy Montanez Johner,**

*Under Secretary for Food, Nutrition and Consumer Services.*

[FR Doc. E7-21420 Filed 10-30-07; 8:45 am]

**BILLING CODE 3410-30-P**

**NATIONAL CREDIT UNION ADMINISTRATION**

**12 CFR Part 701**

**Federal Credit Union Bylaws**

**AGENCY:** National Credit Union Administration (NCUA).

**ACTION:** Final rule.

**SUMMARY:** NCUA is issuing a rule reincorporating the Federal Credit Union (FCU) Bylaws into NCUA regulations. This change clarifies NCUA's ability to use a range of enforcement authorities, in appropriate cases, to enforce the FCU Bylaws. In addition, NCUA is adding a bylaw provision on director succession, an issue it has previously addressed in legal opinions, and is revising the introduction to the Bylaws to conform it to these changes.

**DATES:** This rule is effective November 30, 2007.

**FOR FURTHER INFORMATION CONTACT:** Elizabeth Wirick, Staff Attorney, Office of General Counsel, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428 or telephone: (703) 518-6540.

**SUPPLEMENTARY INFORMATION:**

**A. Background**

On May 24, 2007, the Board issued a Notice and Request for comments on the proposed reincorporation of the Federal Credit Union Bylaws (proposal). 72 FR 30984 (June 5, 2007). The proposal also included bylaw provisions on director succession, an expedited approval process for bylaw amendments previously approved for other FCUs,