United States Department of Agriculture

Food and Nutrition Service

3101 Park Center Drive
Alexandria, VA
22302-1500

DATE: January 23, 2007

MEMO CODE: SP 02-2007

SUBJECT: School Districts and Federal Procurement Regulations

TO: Regional Directors
Special Nutrition Programs
All Regions

State Directors
Child Nutrition Programs
All States

We have received numerous inquiries in the past several weeks concerning a document produced by the Harrison Institute for Public Law at Georgetown University addressing the purchase of products from local farmers. The document expresses the view that Congress, as part of the 2002 Farm Bill, expressed clear support for geographic preferences in purchases made for school food service programs.

That interpretation is incorrect and FNS disagrees with it as a result. Federal procurement regulations at 7 CFR 3016.60(c) clearly prohibit the use of State or local geographic preferences. All purchases made with nonprofit school food service account funds are to be made competitively, consistent with Federal laws and regulations.

Further discussion of this issue can be found in Q&As we published on May 20, 2003 and April 29, 2005. The Q& A's are attached and can also be found at www.fns.usda.gov/cnd/Governance/policy.htm.

Original Signed

STANLEY C. GARNETT
Director

Child Nutrition Division

Attachments

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United States Department of Agriculture

Food and Nutrition Service

3101 Park Center Drive
Alexandria, VA
22302-1500

May 20, 2003

SUBJECT: Applicability of Federal Requirements to School Food Service Procurements

TO: Regional Director
Child Nutrition Programs

In August 2000, a final regulation published in the Federal Register moved the procurement procedure requirements for the Child Nutrition Programs from Department regulation 7 CFR Part 3015 to 7 CFR Parts 3016 and 3019. Attached are a number of questions and answers we have received concerning how these requirements changed the procurement procedures for public and nonprofit school food authorities (SFAs). This memorandum has been reviewed by the Department's Office of the General Counsel.

Please provide this information to your State agencies (SAs) and request that it is shared with all SFAs. We also encourage each SFA to share this information with their legal counsel and recommend each SA share this information with the chief State legal official. If you have any questions, please contact Terry Hallberg, Branch Chief, Program Analysis and Monitoring Branch, at (703) 305-2590.

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Director
Child Nutrition Division

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Questions & Answers:
Applicability of Federal Requirements to School Food Service Procurements

Question 1: **How did regulations 7 CFR Parts 3016 and 3019 change the procurement procedures for public and nonprofit SFAs?**

Answer: The Part 3016 regulation implements the concept of Federalism for public SFAs administering the child nutrition programs. Pursuant to Part 3016.36(b), public SFAs will use their own procurement procedures that reflect applicable State and local laws and regulations, as long as those procedures are consistent with the requirements found at §3016.36(b) through (i) and §3016.60(b) through (c). An SFA may establish any procurement or contract procedure or requirement that is within its authority to establish, so long as the procedures and requirements are consistent with §3016.36(b-i) and §3016.60(b-c).

A nonprofit SFA may elect to follow the procurement procedures at §3019.40-.48 or use its own organizational procedures as long as those procedures are consistent with the requirements of Part 3019.

Question 2: **Please explain §3106.36(b-i) and §3016.60(b-c).**

Answer: 7 CFR Part 3016.36(b-i) establishes the minimum standards an SFA must follow to conduct a proper procurement. These standards address such elements as the requirement that an SFA have a written code of conduct governing the performance of employees engaged in the award and administration of contracts (§3016.36(b)(3)); methods of procurement (§3016.36(d)); the requirement that the SFA perform a cost or price analysis for every procurement, including contract modifications (§3016.36(f)); and required contract clauses and certifications (§3016.36(i)). For additional information, please consult regulation 7 Part 3016.

The requirement at §3016.60(b), allows an SFA to award a contract to a potential contractor that provided information to the SFA that the SFA used in its drafting of specifications, bid, proposal or contract terms, but prohibits the award of a contract to a potential contractor when the potential contractor actually drafted the specifications, bid, proposal, procurement or contract terms. The SFA alone is responsible for developing the documents used in conducting its procurements. 7 CFR Part 3016.60(c) prohibits the use of in-State and local geographic preferences in the award of contracts.

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Question 3: **Does regulation 3019 contain the same requirements and prohibitions for nonprofit SFAs?**

Answer: The minimum standards (§3019.40-.48) nonprofit SFAs must follow in conducting procurements are generally the same as those that apply to public SFAs. While a nonprofit SFA cannot award a contract using an in-State or local geographic preference, Part 3019 does not contain a corresponding prohibition to §3016.60(c). The specific prohibition is not necessary in Part 3019 because nonprofit SFAs lack the legal standing to establish in-state or local geographic preferences. Nonprofit SFAs have been prohibited from awarding contracts to potential contractors that drafted procurement documents since the mid-1970s. That prohibition is stated at §3019.43.

Question 4: **Do the specific procurement and contract clause requirements of the Program regulations still apply?**

Answer: Yes. For example, the Part 210.16 requirements regarding the 21-day cycle menu requirement (§210.16(a) (1)), specific clauses at §210.16(c) and duration of contracts (§210.16(d)) still apply to food service management company (FSMC) procurements and contracts.

Question 5: **Does applying Parts 3016 and 3019 to SFA procurements change FNS' position on the crediting of discounts and rebates in cost reimbursable contracts?**

Answer: No. FNS' position on this subject remains unchanged. FNS strongly encourages, but does not require, that all cost reimbursable contracts include provisions to ensure SFAs are only charged net, allowable costs. The Office of Management and Budget and the Department's Office of the General Counsel have made clear that SAs and SFAs can impose compliance with net cost requirements through contractual terms.

Question 6: **Does Federalism prevent the SA from establishing procurement and contract requirements that SFAs must follow?**

Answer: No. Consistent with the "flow down" concept of Federalism, a SA may establish procurement and contract requirements that SFAs must follow, as long as those requirements are not inconsistent with Program requirements.

Question 7: **Can an SFA follow the procurement procedures at §3016.36(b-i) instead of its own State and local requirements?**

Answer: No, an SFA cannot substitute §3016.36(b-i) for more restrictive State or local requirements.

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Question 8: **Whom should a SA contact to obtain information about the procurement requirements that apply to public SFAs?**

Answer: SAs should seek guidance from their State procurement officials and legal counsel or the chief State legal official.

Question 9: **If State law exempts public schools from complying with State bid laws, is the SFA exempt from all procurement requirements?**

Answer: No. The SFA would still be required to comply with local procurement requirements, any applicable Program requirements and the provisions of §3016.36(b-i) and §3016.60(b-c).

Question 10: **Are there any actions a SA must take when it determines its SFAs must follow §3016.36(b-i) because there are no State or local procurement requirements applicable to SFA procurements?**

Answer: Yes. In the committee report language accompanying Public Law 105-336, the William F. Goodling Child Nutrition Reauthorization Act of 1998, Congress informed USDA that it "should be prepared to promptly and fully account to the Committees of jurisdiction for each instance in which federal authorities address a matter of a subgrantee procurement." As a result, FNS is requesting the SA provide written confirmation from the chief State legal official that the State's public SFAs must follow §3016.36(b-i) because no applicable State or local requirements apply to its public schools.

Question 11: **If questions or disputes arise concerning a public SFA's procurement practices or contracts, do we still contact FNS for guidance?**

Answer: No. These issues include contract management and compliance matters such as questions related to source evaluations, protests, disputes and claims. FNS will not substitute its judgment for that of the SA or SFA on these issues unless the matter is primarily a Federal concern. FNS will, however, take the necessary steps to assure compliance with the procurement requirements contained in §3106.36(b-i); §3016.60(b-c); §3019.40-.48 and the school nutrition program regulations.

Since disputes may result from the application of State and local laws, regulations and policies, we recommend both SAs and SFAs direct these disputes to appropriate State procurement and legal officials and the SFA's own local legal counsel. This includes any dispute arising from the SA's decision requiring SFA compliance with one or more of the procurement procedures contained at §3016.36(b-i) and any decision by a SA or SFA to expand the procurement procedures at §3016.36(b-i).

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Question 12: **Doesn't the Federalism concept result in differences between States regarding procurement procedures and contract requirements and even between SFAs within the same State?**

Answer: While procedural practices may differ, the fundamental requirements do not. Most public SFAs already operate under requirements that recognize the procurement principles incorporated in Part 3016, such as the requirement for full and open competition and the prohibition against conflicts of interest. To the extent procurement requirements do not exist or are less restrictive than those contained in Part 3016, the common rule requirements continue to apply. In addition, as noted above, all school nutrition program regulations applicable to procurement and contact management, such as the requirement that federally donated commodities accrue only to the benefit of the school food service (7 CFR 210.16(a)(6)) and the Buy American requirement (7 CFR 210.21(d)), continue in effect. With respect to all contracts, including those with FSMCs, SFAs are free to include procurement and contract management requirements in their contract with these companies. FNS strongly encourages SFAs include, in all solicitations and contracts, terms that protect the nutritional and financial integrity of the school nutrition programs. Such terms may include requirements in cost reimbursable contracts that FSMCs, distributors and brokers obtain goods for the programs through competitive procurements and that all discounts, credits and rebates received by these contractors must be credited to the SFA's nonprofit school food service. Further, FNS encourages SAs develop prototype procurement and contract documents as a means of providing technical assistance to SFAs. FNS is currently considering proposing regulations to ensure greater consistency with respect to the participation of FSMCs and other cost reimbursable contractors in the school nutrition programs.

Thus, although the Federalism principles incorporated in Part 3016 do provide greater flexibility and may result in some procedural variations between States and among public SFAs within a State, such as different small purchase thresholds; the basic requirements for sound procurement and contract management remain in place and will continue to be consistently applied. FNS will fully support SAs and public SFAs that exercise sound administrative practices and good business judgment in establishing procurement practices and contract terms that protect the integrity of the school nutrition programs.

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United States Department of Agriculture

Food and Nutrition Service

3101 Park Center Drive
Alexandria, VA 22302-1500

April 29, 2005

SUBJECT: Recent Procurement Procedure Questions

TO: State agencies
Child Nutrition Programs

Periodically, we receive questions concerning the procurement requirements of 7 CFR Parts 3016 and 3019 and certain procurement procedures used by public and nonprofit school food authorities (SFAs). Attached are a number of these recent questions and their corresponding answers.

Please share this information your SFAs. We also encourage each SFA to share this information with their legal counsel and recommend you share this information with the chief State legal official. If you have any questions, please contact Terry Hallberg, Branch Chief, Program Analysis and Monitoring Branch, at (703) 305-2590.

Original Signed

STANLEY C. GARNETT
Director
Child Nutrition Division

Attachments

cc: Regional Directors, Child Nutrition Programs

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Question 1: If all our schools are equipped with a specific brand of coolers, for which we maintain a supply of replacement parts, and for which our maintenance staff is trained to repair, would we be able to request a specific brand, make, and model as a replacement?

Answer: Yes, with the approval of the State agency (SA). Generally, restricting the procurement to a brand name or specific product is not permitted (§3016.36(c)(vi)). However, situations do arise when a School Food Authority (SFA) has a compelling need, such as compatibility with current equipment, to purchase a brand specific item. In this example, when supporting its request for permission to conduct a procurement for a specific brand of cooler, at a minimum, the SFA would need to document all of the following: The other available brands of coolers are not compatible with the SFA's: (1) current equipment, (2) replacement part inventory, and (3) maintenance staff's expertise. The SA can impose additional requirements prior to approving a brand name procurement.

If approved, the SFA would still need to maximize competition in the brand specific procurement. In the situation presented, there may be more than one equipment distributor carrying the specific product. When an adequate number of equipment distributors did exist, the SA would approve the SFA to conduct a sealed bid procurement to acquire the replacement cooler. In conducting this procurement, the SFA needs to be alert to situations where suppliers are affiliated or associated, which could result in collaboration or restrict competition. On the other hand, if only one supplier is available nationally, the SA can authorize the SFA to conduct a noncompetitive negotiation with that one supplier, if noncompetitive negotiation is allowed under applicable State and local rules.

Question 2: Is the situation described in Question 1 a sole source procurement?

Answer: No. Although a situation exists in which a specific make and model is needed, this is not a sole source procurement. In the Child Nutrition Programs, a sole source procurement occurs only when the goods or services are available from only one manufacturer through only one distributor or supplier. While the specific cooler described in question 1 is only available from one manufacturer, it is highly unlikely that there will be only one national distributor of that cooler.

Question 3: What is the difference between a noncompetitive negotiation and a sole source procurement, since both involve negotiating with a potential supplier?

Answer: Noncompetitive negotiation is a procurement method used to compensate for the lack of competition, while sole source describes a condition of the procurement environment.

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As stated in the answer to question 2, a sole source situation occurs when the goods or services are only available from one manufacturer through only one supplier. In a true sole source situation conducting a traditional solicitation (sealed bid, competitive negotiation or small purchase) is a meaningless act, because the element of competition will not exist. When faced with an actual sole source situation, an SFA must first obtain State agency approval, and then go directly to the one source of supply to negotiate terms, conditions and prices.

Often, a sole source situation is confused with a lack of competition, which occurs when an SFA receives an inadequate number of responses to its solicitation. This lack of competition may result from overly restrictive solicitation documents, an inadequate number of suppliers in the area, or the procurement environment may have been compromised by inappropriate supplier actions, i.e., market allocation schemes. Unlike sole source in which a solicitation is not issued, noncompetitive negotiation occurs after the solicitation (sealed bid, competitive negotiation or small purchase) has been issued, but competition on that solicitation has been deemed inadequate.

Noncompetitive negotiations are restricted to specific situations and may only be used when: (1) there is inadequate competition in a formal competition, (2) a public emergency exists, or (3) the awarding agency provides prior approval. Regardless of the circumstance, due to the absence of full and open competition, a contract cannot be awarded unless negotiations are actually conducted with one or more potential contractors. Negotiations must include both price and terms using the same procedures that would be followed for competitive proposals.

Question 4: Can a distributor, that carries multiple brands of pizza, bid and receive an SFA’s pizza contract if the distributor wrote the SFA’s pizza specification?

Answer: No. 7 CFR Part 3016.36(b) prohibits an SFA from entering into a contract with a potential contractor that develops or drafts specifications, requirements, statements of work, invitations for bids, requests for proposals, contract terms and conditions or other documents for use in conducting a procurement. Regardless of the number of pizza products available through the distributor, if a distributor wrote the specification used in the SFA’s pizza bid, the distributor is not eligible for the award.

However, if the distributor simply provided information to the SFA about all or only one of its pizza products, and the SFA wrote its own pizza product specifications, the distributor would still be eligible to compete for the procurement. 7 CFR Part 3016.36(b) is not concerned with potential contractors that simply provide information, but rather with those individuals and firms that are actually writing specifications, evaluation criteria, and other contract terms and conditions.

SFAs must have sufficient information to develop well-written specifications and procurement solicitations. SFAs can obtain adequate and pertinent information through a variety of sources, including trade shows, market research, conferences, and discussions with manufacturers and suppliers. Using all of these resources allows the

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SFA to develop a well-written solicitation that promotes full and open competition, which in turn leads to competitive responses and the best products and services at the best price.

Question 5: What are the "other documents" referenced in this phrase from 7 CFR Part 3016.60(b): "In order to ensure objective contractor performance and eliminate unfair competitive advantage, …a person that develops or drafts specifications, requirements, statements of work , invitations for bids, requests for proposals, contract terms and conditions or other documents for use by a grantee or subgrantee in conducting a procurement under the USDA entitlement programs…shall be excluded from competing for such procurements."?

Answer: "Other documents" refers to any documents that are used in any aspect of a procurement. This can include, but is not limited to, evaluation criteria, ranking criteria, bidder responsibilities, bidder requirements, SFA procurement practices, contract terms and conditions, payment terms, and SFA contract administration procedures. It is important to remember, that a procurement is not limited to the solicitation process but includes all of the elements of the process from the initial determination that goods or services are needed through the retention of records following the expiration of the contract.

Question 6: We would like to use a pre-approved product list. Do SFAs need to get prior approval from the SA to use a pre-approved products list?

Answer: Yes. While 7 CFR Part 3016.36(c)(4) allows for the use of pre-approved or pre-qualified lists of persons, firms, or products, an SFA should always check with its SA concerning applicable State laws. The SFA should also check with appropriate local procurement officials to ensure pre-approved product lists are permitted under applicable local procurement laws.

Question 7: Can I limit bidders to a pre-approved suppliers/pre-approved products list?

Answer: Yes, as long as you are not prohibited from using such lists under applicable State and local laws and the SFA's procurement procedures still ensures maximum open and free competition. The procedures the SFA will follow when conducting a procurement using a pre-approved suppliers list depends on the procedures that were used to place the suppliers on the list. Some pre-approved supplier lists are nothing more than mailing lists of potential suppliers, i.e., any supplier that may be interested in competing for the SFA's business can be included on the list. In other cases, suppliers and their products are subject to a comprehensive competitive evaluations and must compete with other suppliers before being included on the list.

When using the "mailing list" form of a pre-approved supplier list, the SFA must still develop comprehensive procurement documents, complete with adequate specifications

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and evaluation criteria and must still publicly announce the solicitation, in addition to contacting the potential suppliers on the list.

With the second form of pre-approved suppliers list, a technical evaluation of the supplier's products and eligibility to participate in a contract with the SFA occurs prior to adding the supplier's name to the list. In some cases, the prices of the products have been established through this competitive process, but not delivery or handling charges. When using this form of pre-approved supplier, the SFA would initiate a competitive procurement for those features that had not previously been subject to competition, but can limit responsive bidders to those suppliers/products on the pre-approved list.

In all cases, the SFA must make sure that (1) the list is current; (2) a suitable number of qualified sources exist on the list; (3) when applicable, the product or services on the list are specific in nature, not just a general such as food, supplies, etc.; (4) all potential suppliers had the opportunity to be included on the list; (5) when applicable, all potential suppliers were subject to the same evaluation and ranking criteria; (6) suppliers that did not request or when applicable, compete, for inclusion on the list are not on the list; (7) lists are updated at least annually; (8) the opportunity exists to add new qualified suppliers; (9) potential suppliers are not prohibited from qualifying for inclusion on the list during the solicitation period; and (10) a system exists to remove listed suppliers, for cause.

Question 8: We have received a memo from FNS dated October 13, 2004, regarding SFAs copying specifications directly from Horizon Software materials for their solicitations. Is FNS aware of SFAs directly copying specifications from other companies associated with school food service?

Answer: Our office has received anecdotal information regarding SFAs directly copying specifications and feature descriptions from companies, other than Horizon, for use in solicitation documents for software services, as well as for management company services, food purchases, and food service equipment purchases.

The purpose of the memo, dated October 13, 2004, was to remind SFAs of the provisions of §3016.60(b). As you are aware, §3016.60(b) prohibits an SFA from entering into a contract with a person that develops or drafts specifications, requirements, statements of work, invitations for bids, requests for proposals, contract terms and conditions or other documents for use in conducting a procurement.

In many instances, the company may not be aware that an SFA has copied available company information verbatim, or a SFA may utilize the specifications from another SFA's solicitation without knowing that the original solicitation itself was improperly copied from a company's literature, specification, website, etc.

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Question 9: Often SFAs will share bid specifications and other documents. What steps should a SFA take to make sure that these documents were not drafted by a potential contractor?

Answer: An SFA that uses another SFA's solicitation or contract documents, should always inquire as to the origin of the information so that they do not unintentionally violate the provisions of §3016.60(b). The SFA should pursue its inquiry until the original author of the documents is identified.

Question 10: A few years ago, I attended a session at the American School Food Service Annual Conference in Minneapolis, Minnesota on factors to consider when writing bid specifications for software systems. Is it a problem if I use information from the handout I received at that session to help me prepare the specifications for my software procurement?

Answer: No. FNS encourages SFAs to obtain information from as many sources as possible when developing procurement specifications. The handout referenced in Question 10 provided general information and was not specific to any one potential contractor's system. We have attached a copy of the handout, which we have updated to reflect current Department procurement requirements, since it may be of interest to other SFAs.

Question 11: Are Farm-to-School efforts exempt from the prohibition on using in-State or local geographic preferences?

Answer: No. Section 4303 of the Farm Security and Rural Investment Act of 2002 adds a new paragraph (j) at the end of section 9 of the Richard B. Russell National School Lunch Act pertaining to purchases of locally produced products. The provision requires the Secretary to encourage institutions participating in the school lunch and breakfast programs to purchase locally produced foods, to the maximum extent practicable.

However, in review of the Committee Notes to the 2002 Farm Bill, page 124 (note 53), although encouraging the purchase of locally produced product, Section 4303 does not allow for geographic preferences, "It is not the intent to create a geographical preference for purchases of locally produced foods or purchases made with grant funds." The notes continue by stating, "The Managers want to make clear that SFAs are still required to follow federal procurement rules calling for free and open competition and limit local product purchases to those that are practicable."

Therefore, although school food authorities participating in the National School Lunch and School Breakfast Programs are encouraged to purchase locally produced foods, to the maximum extent practicable, this provision does not permit SFAs to use in-State or local geographical preferences. SFAs should always remember that all purchases must be made competitively, consistent with Federal and State procurement laws and regulations.

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Question 12: Does USDA's efforts to promote Farm-to-School mean schools do not have to follow procurement rules?

Answer: No. Although the Farm-to-School initiative was developed to encourage schools to purchase fresh fruits and vegetables from small, local farmers and growers, SFAs must make all purchases in accordance with all Departmental procurement regulations and applicable State and local laws and statutes. However, this does not preclude SFAs from identifying potential local farmers or providing these farmers with its procurement solicitations. Further, an SFA can inform its local farmers of its interest in particular fresh fruits and vegetables so that the local farmers may plan future crop plantings accordingly. It is important to note that Farm-to-School purchases are often less than the applicable small purchase threshold. In these cases, SFAs are able to use these relatively simple, informal procedures to obtain these desirable products.

Finally, all produce purchases made through the Department of Defense meet USDA procurement regulatory requirements and SFAs may pursue Farm-to-School goals through coordination with the designated DoD Produce Buying Office.

Question 13: Our State laws exempt SFAs from following procurement rules. Does this mean that we are exempt from the requirements of Part 3016?

Answer: No. State or local laws may not exempt SFAs from following the Federal requirements of the National School Lunch Program. In the absence of State or local laws, rules and statutes, a public SFA must follow minimum procurement requirements at §§3016.36(b) through (i) and 3016.60.

Question 14: Our State laws exempt the purchase of perishable products from procurement rules. Does this mean that we are exempt from the requirements of Part 3016?

Answer: No. Similar to Question 13, State or local laws may not exempt SFAs from following the Federal requirements of the National School Lunch Program. When purchasing perishable products such as produce and dairy, one effective approach is to use a fixed price contract with economic adjustment for the product and fixed fee for the delivery. This form of contract provides for upward and downward revisions of the stated contract price based upon specified events using indexes or standards, such as the CPI or Dairy Market Measures. This allows suppliers to protect against wide price fluctuations in the market, thereby providing more competitive and favorable bids for SFA solicitations.

Question 15: Our State agency requires that we use a mandated prototype contract when contracting with a food service management company. The management company we selected has returned our State prototype contract with a couple of adjustments that they say will help us save money. Can I allow them to do so?

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Answer: Since the prototype contract was developed and its use is mandated by the SA, only the SA can decide whether it will permit changes to that document. In making its assessment, that SA needs to determine if the changes are material (i.e., other potential contractors may have chosen to bid differently had they known of the change) or are in violation of the requirements of §3016.60(b), which prohibits awarding a contract to a contractor that develops contract terms and conditions. Generally, if the proposed changes are material and the SA agrees that the changes are beneficial, the SA should amend its current prototype contract and the SFA should undertake a new procurement. If the SA determines the changes are not material, the SFA or the SA, not the contractor, would develop the actual contract terms and conditions.

Question 16: With the price of rising fuel costs, my distributor asked me to include a price adjustment in our current contract to help him recover some of his costs associated with these increases. I can see his argument. Can I give him an increase?"

Answer: Price changes are permitted only when the SFA included terms for these price changes in its solicitation and contract documents. When the SFA agrees that a price adjustment factor is appropriate but did not include the adjustment factor in its procurement documents, the SFA needs to conduct a new procurement that includes the adjustment factor.

Question 17: My contract with a distributor is a fixed price for the products for the entire term (12 months) of the contract with a fixed fee for delivery and service expressed as a percentage of the product fixed price as. Is this a "cost plus percentage of cost" contract.

Answer: No. The contract described in question 17 is a fixed price for goods with a service fee expressed as a percentage of the fixed cost. In an actual cost plus percentage of cost contract, the percentage mark-up is added to the cost of the product, which is not fixed but changes over the term of the contract. This is the type of cost plus percentage of cost contract that is prohibited by §3016.36(f)(4). An example of a prohibited cost plus percentage of cost contract provision would be: "The distributor will be paid the cost of goods plus 10% of these costs." In this type of pricing structure the distributor is rewarded for increased costs, and therefore has no incentive to provide the SFA with the best pricing available.

In the contract described in the question, the contractor will receive a fixed price for the product, and a distribution fee based upon the percentage of the fixed product cost. Since the price of the goods does not change for the contract period, the distribution fee in effect will remain the same, and therefore it is also fixed. The distributor only increases its revenue based upon the actions of the SFA, i.e., increased purchase volume, and not through its own actions, i.e., the purchase of higher-priced product.

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