INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202

REPORT
NO. 91-089 June 6, 1991

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT AND COMPTROLLER)

SUBJECT: Report on the Audit of the Acquisition of the Tactical Air Operations Center/Modular Control Equipment (Project No. 0AS-0057)

Introduction

This is our final report on the Audit of the Acquisition of the Tactical Air Operations Center/Modular Control Equipment (TAOC/MCE) for your information and use. Comments on a draft of this report were considered in preparing the final report. This report contains no recommendations, but addresses matters of concern that could affect the acquisition of the TAOC/MCE. We performed the audit from March through December 1990. The audit objective was to determine the effectiveness of acquisition planning and the execution of the TAOC/MCE program in the production phase. We also evaluated internal controls related to the audit objectives. The audit was made in accordance with the Inspector General's critical program management element approach. The Marine Corps is the lead Service for this joint Marine Corps and Air Force program. The TAOC/MCE program office, Space and Naval Warfare Systems Command (SPAWAR), manages the program. Research, Development, Test and Evaluation, and Procurement funding for the TAOC/MCE program through FY 1991 totaled about $1.3 billion.

Scope of Audit

This economy and efficiency audit was conducted in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD, and accordingly included such tests of internal controls as were deemed necessary. We obtained and reviewed accounting and program data and information for the period January 1984 through December 1990 to support the audit. We interviewed personnel involved in the acquisition of the TAOC/MCE and personnel involved in the areas audited. The Technical Assessment Division of the Office of the Assistant Inspector General for Auditing assisted in the areas of developmental and operational testing and software maintenance training. A list of the activities visited or contacted is in Enclosure 5.

Internal Controls

Internal controls were reviewed as deemed necessary for the eight critical program management element objectives addressed during the audit. Internal controls for the objectives were determined from applicable DoD, Navy, Air Force, and Marine Corps directives, instructions, and manuals. Except as noted in the areas of test and evaluation and contract procedures, we found that the internal controls over the areas reviewed were adequate. Enclosure 1 provides a summary of the six critical program management element objectives where controls were adequate.

Background

The TAOC/MCE is a transportable air command and control system capable of controlling and coordinating the employment of a full range of air defense weapons, interceptor aircraft, and surface-to-air missiles. The primary functions of the weapon system include air surveillance, weapons control, air traffic control, electronic warfare, and training.

In May 1987, the Navy awarded Litton Data Systems (Litton) a fixed-price-incentive-fee contract for $670.5 million that included initial production quantities in FY 1987 and options for additional production quantities in FY's 1988 and 1989. The contract provided for Litton to begin producing 11 units in FY 1987, of which 8 units were designated to support initial operational tests of production-representative units. The Navy subsequently exercised the FY 1988 and FY 1989 options for 25 units and 27 units, respectively. In September 1990, the Navy awarded Litton a firm-fixed-price contract modification for another 33 units and ancillary equipment for FY 1990 costing $201.9 million, a FY 1990 option for an additional 7 units costing $41.4 million, and a FY 1991 option for up to 38 units costing $205.5 million. No further production buys are planned after the FY 1991 contract option is exercised.

Prior Audit Coverage

There were no prior audits covering the subject area in the last 5 years.

Discussion

We found that, in general, the acquisition planning and execution of the program were effective. However, there were matters of concern that may affect the acquisition of the TAOC/MCE. The Marine Corps and Air Force proceeded with TAOC/MCE "de facto" full-rate production decisions before conducting operational tests of production-representative units. The lack of operational testing may negatively impact system performance when it is deployed. We identified incentive fee provisions, competition credit determination procedures, files maintenance, Level III drawings, contractor claims, and subcontractor progress payments as contract matters requiring further management emphasis.

Operational Tests. The Conference Report in the 1984 Department of Defense Authorization Act stated that low-rate production was "...the production of a system in limited quantity to be used in operational test and evaluation for verification of production engineering and design maturity and to establish a production base prior to a decision to proceed with production." The 1990 National Defense Authorization Act for FY's 1990 and 1991 refined the definition of low-rate initial production as the minimum quantity to "...provide production-configured or representative articles for operational tests...to lead to full-rate production upon the successful completion of operational testing." The definition was refined because of congressional concerns that DoD was purchasing a large share of the total procurement program, under the guise of low-rate initial production, before completing initial operational tests and evaluations.

In the case of the TAOC/MCE, the Marine Corps and the Air Force did not plan or conduct operational tests on production-representative low-rate initial production units before proceeding with "de facto" full-rate production decisions. Also, low-rate production quantities were not limited to the eight units required to support initial operational tests of production units or the minimum quantity needed to sustain Litton's production base. Specifically, Marine Corps and Air Force operational tests will not occur until the first quarter of CY 1992, about 1 year after the Navy's planned award of the final production option in March 1991. In FY's 1988 through 1990, SPAWAR awarded Litton annual production quantities that exceeded the minimum annual requirement to sustain Litton's production base of 18 units. Because of test plan shortcomings, the Director, Operational Test and Evaluation and the Deputy Director, Defense Research and Engineering (Test and Evaluation), had not approved the Joint Test and Evaluation Master Plans that the program office had submitted since April 1986, when the TAOC/MCE was designated for OSD oversight. As a result, the Marine Corps and Air Force will have committed about $1.0 billion in procurement funds to complete all TAOC/MCE production requirements before demonstrating that the units were operationally effective and suitable.

The TAOC/MCE program office considered program risks to be low based on test results obtained from earlier developmental and operational tests made of the engineering development model. Follow-on operational tests of the engineering development model showed that earlier performance deficiencies were corrected or were being satisfactorily resolved through engineering design changes. Accordingly, the program office plans to exercise the final production option in March 1991. We concluded that a recommendation to slow production of the TAOC/MCE procurement process was not appropriate because the final buy will occur by March 1991, and operational tests of the engineering development model showed positive results.

Contract Incentive Fee Provisions. We applaud the Navy's increase in subcontract and subassembly competition on the TAOC/MCE production contract through up-front investments in subcontract requirements documents and contract incentive fee provisions. With respect to using contract incentive fee provisions, the Federal Acquisition Regulation (FAR), subpart 16.401(a)(2), "Incentive Contracts," requires contracting officers to design the incentive arrangements to motivate contractor efforts that might not otherwise be emphasized. Before finalizing the competition incentive fee structure for the TAOC/MCE contract, the Government took the following actions.

- The TAOC/MCE program office invested over $635,000 to establish subcontract requirements documents that reflected production specifications and statements of work.

- The Navy Procurement Contracting Officer (PCO) ensured that Litton had initiated competition for all subcontracted items and had received initial competitive quotes on the majority of the major subcontracted items.

- The PCO obtained Litton's own estimate of expected competition levels that would be attained without extraordinary contractor efforts.

- The PCO surveyed contractors to determine potential subcontractor competition.

- The Defense Contract Administration Services Region, Los Angeles, performed a Litton purchasing system review in 1985, which showed that Litton normally achieved competition for about half of all subcontracts awarded.

Based on the results of the above actions, we believe the PCO did not fully consider their effect in designing the competition incentive fee. In our opinion, Litton's success in attaining subcontract competition goals will not, to a large extent, result from extraordinary contractor efforts to increase competition after the contract award but from the Navy's up-front efforts to increase competition before the contract award. Accordingly, we believe that the Navy may pay Litton incentive fees for subcontract competition levels that would have otherwise occurred without contract incentives. If the Navy intends to continue using this type of incentive, it needs to issue guidance clarifying when it is appropriate to use this type of incentive and what factors should be considered in designing the competition incentive fee structure.

Competition Credit. The PCO established a competition credit measurement system in the TAOC/MCE production contract that was not compatible with Litton's accounting and material control system. Instead of incurring the cost to modify its existing system, Litton implemented an alternate competition credit measurement system, which was not consistent with contract requirements. The PCO and the Administrative Contracting Officer had taken steps to validate Litton's measurement of competition credit earned through its alternate system but had not taken actions necessary to resolve this contract problem. Timely resolution of the differences between the contract requirements and the measurement system requires management attention.

Contract Files. The SPAWAR contract office was unable to locate the complete TAOC/MCE contract file for production contract N00039-87-C-0330. The contract office attributed the missing documents to insufficient funding to adequately maintain the contract files and to the Federal Bureau of Investigation's confiscation of files for an investigation. The Bureau advised us that the TAOC/MCE was not among the acquisition programs included in its investigation. FAR, subpart 4.802(c)(2), "Contract Files," requires maintenance of contract files to ensure accessibility to users. Documentation in the files constitutes a history of the contract transactions to support actions taken and to provide information for reviews, investigations, and future actions. Continued Navy contract management oversight over file maintenance is required to comply with the FAR requirements.

Level III Drawings. The TAOC/MCE program office did not procure Level III drawings in time to support a system level competition for the second production contract. As part of the acquisition strategy, the TAOC/MCE program office cited this acquisition objective in its acquisition plan, which was approved in 1986. During the audit, the TAOC/MCE program office advised us that the procurement of Level III drawings was not to be used to support system level competition but to induce Litton to propose fair and reasonable prices for the second production contract. The program office stated that it could solicit production proposals with Level III drawings from prime contractors other than Litton. Accordingly, Litton would have to compete for the remaining system requirements in FY's 1990 and 1991. The program office's late action to obtain Level III drawings, which cost $9.2 million, resulted in the drawings not being available when Litton's contract was modified for FY 1990 and FY 1991 production buys. The TAOC/MCE program office indicated that the Level III drawings will be used to support Air Force Logistics Command requirements. Use of Level III drawings will not be viable unless management ensures that the Air Force Logistics Command receives them in a timely manner.

Contractor Claims. Litton's claim for reimbursement for special tooling and test equipment costs under the contract change clause and its proposal to include foreign military sales related expenses in the general and administrative overhead pool may increase TAOC/MCE production contract costs by $12.5 million. In March 1987, the Defense Contract Audit Agency (DCAA) cited Litton for noncompliance with the FAR and cost accounting standards for including special tooling and test equipment depreciation costs in its general purpose equipment cost pool. The FAR provides that an indirect cost is any cost not directly identified with a final cost objective. The special tooling and test equipment costs were identifiable to a specific cost objective, and to include them as indirect costs would violate the FAR provisions. In October 1987, the Divisional Administrative Contracting Officer (DACO) sustained DCAA'S position on this issue. Litton contested the DACO's determination and submitted a $7.9 million equitable adjustment claim to the PCO in December 1988. As of January 1991, the PCO had not decided on the allowability of the equipment costs. In August 1990, Litton proposed an accounting change to the DACO to include certain foreign marketing expenses in its Foreign Military Sales general and administrative cost pool, as authorized by the 1988 National Defense Authorization Act for Fiscal Year 1989. These marketing expenses included costs to promote the export of Defense products, such as costs to exhibit and demonstrate products. If accepted by the DACO, Litton's proposed change will increase contract costs by about $4.6 million through increased overhead rates. Continued management oversight is needed to ensure timely resolution of Litton's claim for reimbursement for special tooling and test equipment costs and its proposed accounting change related to the allowability of foreign marketing expenses.

Subcontractor Progress Payments. Grumman Aerospace Corporation (Grumman), one of Litton's subcontractors for the TAOC/MCE, included unpaid supplier invoices totaling $43,131 in its June 1990 progress payment request, which was reimbursed by Litton. FAR, subpart 52.232-16, "Progress Payment," allowed Litton to request progress payments for paid costs of supplies and services purchased directly for the contract from its subcontractors. FAR, subpart 32.504, "Subcontracting," allowed Litton to provide progress payments to Grumman. Litton included the required progress payments clause, which coincided with its progress payment clause, in its subcontract with Grumman. The subcontract clause specified that Litton was responsible for administering and paying the subcontractor's progress payments. Litton, when billed by Grumman, included the subcontractor's unpaid vouchers in its progress payment billing to the Government. While the Government's interest expense related to the progress payment was not significant, the Administrative Contracting Officer should continue emphasizing to Litton the requirement to adequately monitor subcontractor progress payment requests before making payment.

We issued the draft memorandum report on February 27, 1991, without findings or recommendations. Although management comments were not required, the Assistant Secretary of the Navy (Research, Development and Acquisition) provided comments on April 26, 1991, and supplemental comments on May 24, 1991. The complete texts of the Navy's comments and our detailed audit responses are included in Enclosures 2, 3, and 4, respectively. This report identified no potential monetary benefits. Any comments on this final report should be provided within 30 days of the date of this memorandum.

The courtesies extended to the audit staff are appreciated. A list of the audit team members is in Enclosure 6. If you have any questions on this audit, please contact Mr. John E. Meling at (703) 614-3994 (DSN 224-3994) or Mr. Thomas Bartoszek at (703) 693-0481 (DSN 223-0481). Copies of this report are being provided to the activities listed in Enclosure 7.

Robert J. Lieberman

Robert J. Lieberman
Assistant Inspector General
for Auditing

Enclosure

cc:
Secretary of the Navy
Secretary of the Air Force

SUMMARY OF CRITICAL PROGRAM MANAGEMENT ELEMENTS WITH ADEQUATE CONTROLS

During the survey phase of the audit, we determined that additional audit work was not warranted in the following management elements.

System Design Maturity. The system design for the Tactical Air Operations Center/Modular Control Equipment (TAOC/MCE) had stabilized and had been adequately documented by the TAOC/MCE program office and Litton Data Systems (Litton). In addition, the TAOC/MCE program office had performed functional and configuration audits to establish a design baseline and to validate the technical data package before releasing the system into production.

Validity of Initial Threat Assessment. In July 1989, the Air Force Intelligence Agency approved the System Threat Assessment Report, which reviewed the threat to degrade or defeat the TAOC/MCE. Headquarters, Tactical Air Command, published the System Operational Requirements Document in August 1989. The Document stated that the system would satisfy the mission need. In February 1987, the Marine Corps updated its Required Operational Capability Document with the latest system threat assessment. The Marine Corps also determined that the system would meet the mission needs.

Configuration Management Procedures. Configuration management plans, procedures, processes, and records had been prepared and were adequate for the TAOC/MCE. Also, we made a limited test of the configuration control system and determined that it was functioning as required.

Cost or Price Analysis. Pre- and post-negotiation business clearance documents showed that required cost and price analyses were completed before the award of the TAOC/MCE production contract. In this respect, the documents showed that the Defense Contract Audit Agency had reviewed Litton's estimating system and had performed a preaward audit of material costs. Further, the Space and Naval Warfare Systems Command had performed a cost evaluation of the production proposal for all cost elements.

Component Breakout. TAOC/MCE component breakout was not a viable option because of program budget cuts. No further TAOC/MCE production will occur after the Navy exercises Litton's FY 1991 production contract option.

Logistics. All logistics plans, procedures, and records were prepared and updated, as required in Air Force and Marine Corps system acquisition procedures. The plans, procedures, and records were adequate to support the TAOC/MCE acquisition.

THE ASSISTANT SECRETARY OF THE NAVY
(Research, Development and Acquisition)
WASHINGTON, D.C. 20350-1000

APR 26 1991

MEMORANDUM FOR THE DEPARTMENT OF DEFENSE ASSISTANT INSPECTOR GENERAL FOR AUDITING

Subj: DRAFT REPORT ON THE ACQUISITION OF THE TACTICAL AIR OPERATIONS MODULE/MODULAR CONTROL EQUIPMENT (PROJECT NO. 0AS-0057)

Ref: (a) DODIG memo of 27 Feb 1991

Encl: (1) DON Comments on the Draft Audit Report

I am responding to the draft audit report forwarded by reference (a), concerning the effectiveness of acquisition planning and the execution of the Tactical Air Operations Center/Modular Control Equipment program.

Although the report contains no findings or recommendations, there are several matters of concern that we feel should be clarified with regard to the contract and business matters portion of the report. Department of the Navy comments are provided in enclosure (1).

Gerald A.Cann

Copy to:
NAVINSGEN
NAVCOMPT (NCB-53)

DEPARTMENT OF THE NAVY COMMENTS ON THE DRAFT
DODIG AUDIT REPORT ON THE ACQUISITION OF THE TACTICAL
AIR OPERATION MODULE/MODULAR CONTROL EQUIPMENT
(PROJECT NO. 0AS-0057)

In general, we are pleased with the progress of the review reflected in this document. The audit staff has acquainted itself thoroughly with the technical issues under its review and has drawn appropriate conclusions. However, we continue to be concerned over the portion of the report addressing contract and business matters; these are discussed under the various "matters of concern" identified below. These and other comments are provided as follows:

a. Background, Page 2 - The next to last sentence of paragraph 2 is incorrect. The September 1990 contract modification covered 33 units and ancillary equipment for FY 1990 costing $201.9 million, a FY 1990 option for an additional 7 units costing $41.4 million, and an option for up to 38 units in FY 1991 costing $205.5 million.

b. Matters of Concern, Contract Incentive Fee Provisions, Page 4

First Bullet: The facts concerning government investment require additional amplification. We agree that funds were spent to upgrade specifications and statement of work for subsystems prior to award of the production contract. This was carefully planned action intended to: (1) smoothly transition from engineering development to production, (2) help ensure contractor continuity by providing a bridge effort between engineering development and production, and (3) support Litton's ability to provide a sample of the initial competitive quotes for subcontracts on which to base our estimation of "reasonable and attainable targets" as required by the Federal Acquisition Regulation (FAR) 16.401(a)(1).

The discussion of investment in this area of concern also does not address the considerable investment made by Litton both before and after award to foster subcontract competition. The test suggests that the government absorbed all of the costs associated with the subcontracting competition program, which is not the case.

Second Bullet: This statement should be re-worded to reflect that competitive cost estimates were not received for all the subcontracted items. A more complete and fair understanding of the situation would result from the following:

"The Navy Procurement Contracting Officer (PCO) ensured that Litton had initiated competition for all subcontracted items and had received initial competitive quotes on the majority of the major subcontracted items."

Fifth Bullet: This bullet mentions a Defense Contract Administration Services Region (DCASR) analysis of Litton's purchasing practices. This analysis was conducted prior to a restructuring of Litton's estimating system. The PCO re-examined the historical data using the new estimating standards in order to establish the incentive provisions on an appropriately comparative basis. It should also be noted that company-wide purchasing system results should not necessarily be indicative of the expected results on any individual contract.

Last Paragraph: The first sentence states that the "PCO...did not fully consider" the actions listed on that page. The use of the phrase "fully consider" implies that the PCO did not exercise appropriate diligence in the discharge of business judgement. We strongly disagree with this opinion and feel it should be deleted.

The second sentence should be re-phrased to indicate that this is the auditor's opinion, rather that demonstrable fact. We believe that it can be clearly demonstrated by the examination of actual cost data that Litton has expended a significant effort to obtain high levels of subcontractor competition under the current contract (also, see our discussion of Litton's investment on the previous page).

The third sentence should be re-phrased to indicate that this is the auditor's opinion, rather than demonstrable fact.

The fourth sentence provides a recommendation to the Navy on exercising greater control over this type of contracting. SPAWAR's position is that this procedure was a success, not a failure, and that no change to the Navy's internal controls is required.

During the audit, we provided the audit team a copy of an analysis of the cost benefits of the application of this incentive approach that was prepared for OASN(RDA)(APIA-PP). This analysis clearly demonstrated that the application of the competition incentives saves the Navy over $25 million on the first three production years alone. We have not estimated the long-term savings that will accrue to the government due to the establishment of second sources for the major provisioned items of the system.

c. Matters of Concern, Contract Files, Page 5 - This section addresses the auditor's concerns over the contract files. This section fails to note that SPAWAR is aware of the problems with its file room and is actively undertaking improvements.

d. Matters of Concern, Contractor Claims, Page 6

Special Tools and Test Equipment Claim: The report noted that as of January 1991, the PCO had not made a decision on the allowability of certain equipment depreciation costs. A final PCO decision was issued on February 19, 1991 denying Litton's claim. A significant part of the delay (from approximately January 1989 - June 1989) was attributed to failure on the part of the contractor to provide financial source documentation to Defense Contract Audit Agency (DCAA) to review in support of the claim.

Foreign Military Sales Expense: The issue is whether Litton's proposed Cost Accounting Standards (CAS) change, i.e., the foreign marketing expense in the general and administrative (G&A) pools, would result in an increased cost to the contract. The proposed change is a voluntary change. The Divisional Administrative Contracting Officer (DACO) has advised SPAWAR that voluntary CAS changes are generally only accepted if there is not cost impact to the government or, if there is cost impact, the change must be "desirable" and not "detrimental" to the government. CAS compliance/noncompliance determinations are not the functional responsibility of the PCO; in fact, the DACO, not the ACO, is the official at the Defense Contract Management Command (DCMC) Plant Representative Office with the responsibility to make this determination.

THE ASSISTANT SECRETARY OF THE NAVY
(Research, Development and Acquisition)
WASHINGTON, D.C. 20350-1000

MAY 24 1991

MEMORANDUM FOR THE DEPARTMENT OF DEFENSE ASSISTANT INSPECTOR GENERAL FOR AUDITING

Subj: DRAFT REPORT ON THE ACQUISITION OF THE TACTICAL AIR OPERATIONS CENTER/MODULAR CONTROL EQUIPMENT (PROJECT NO. 0AS-0057)

Ref: (a) DODIG Draft Report Project No. 0AS-0057
(b) ASN(RDA) memo of 26 Apr 1991

The purpose of this memorandum is to supplement Navy comments on reference (a). Previous comments were forwarded by reference (b).

A majority of our previous comments concerned the incentive fee provisions included in the Tactical Air Operations Center (TAOC) production contract. Our comments amplified and, in some cases, took exception to statements made in reference (a). Notwithstanding these differences, it should be understood that the Navy recognizes that contracts which include performance incentives must be carefully structured to insure that the contractors are incentivized to make trade-offs between performance and cost which reflect the best overall interests of the Government. In addition, they must be structured to insure that the contractors are not paid a windfall profit or fee for performance which they probably would have achieved even if the contracts had not included the performance incentives.

In order to avoid potential problems in the future resulting from the use of performance incentives, we will review our existing guidance on this subject to determine if it needs to be reemphasized or revised.

Similarly, we will review the subsection of our Competition Handbook which discusses the cost and performance incentives used for the TAOC production contract to determine if additional guidance is needed concerning up-front investment in prime contractor efforts to increase subcontractor competition and/or the computation of competition credit. We will incorporate additional guidance if it is needed when, and if, the Handbook is republished.

Gerald A. Cann

ENCLOSURE 3

AUDIT RESPONSE TO MANAGEMENT COMMENTS

In the following paragraphs, we are responding to Navy comments on the draft report. Our responses are keyed to management comments on the background information and matters of concern.

Background

We amended the report to clarify information on the September 1990 contract modification.

Matters of Concern, Contract Incentive Fee Provisions

First Bullet (Contractor Investment). Litton did invest $32,572 in a contract to The Stratos Group to devise the Tactical Air Operations Center/Modular Control Equipment (TAOC/MCE) acquisition strategy and competition goals that preserved Litton as the sole source producer of the TAOC/MCE and $99,098 to perform production proposal marketing tasks associated with obtaining competition. However, we did not deem Litton's investment in competition as considerable when compared with the Navy's investment in increasing subcontract and subassembly competition. The Navy invested over $3.1 million to increase competition. As stated in the report, the TAOC/MCE program office invested over $635,000 up front to establish subcontract requirements documents that reflected production specifications and statements of work. In addition, the program office invested another $2.5 million as part of the production contract for Litton to manage the subcontract competitions and second source subassembly contracts. Accordingly, we still maintain that the Navy was, to a large extent, responsible for Litton's success in attaining subcontract competition goals.

Second Bullet (Competitive Cost Estimates). We modified the report as suggested by the Navy.

Fifth Bullet (Litton's Purchasing System). We agree that the results of the purchasing system review by the Defense Contract Administration Services Region (DCASR) may not necessarily indicate the expected results on an individual contract. However, the procurement contracting officer (PCO) should have used the results, for comparison purposes, to evaluate the reasonableness of Litton's proposed competition incentive levels. Although the Navy contends that an analysis was made of Litton's restructured estimating system, the PCO provided us written comments to the contrary. Specifically, the PCO did not derive Litton's normal level of competition from specific source documents but from discussions with program office, DCASR, and Litton personnel.

AUDIT RESPONSE TO MANAGEMENT COMMENTS (continued)

Last Paragraph, First Sentence (PCO's Diligence). The Navy did not provide any additional evidence to alter our opinion that the PCO did not fully consider the effect of the Government's actions taken to increase competition in designing the competition incentive fee.

Last Paragraph, Second and Third Sentences (Litton's Success and Auditor Conclusion). We modified the report as suggested by the Navy.

Last Paragraph, Fourth Sentence (Implied Recommendation). We do not agree with the Navy's position that the procedures followed in establishing the TAOC/MCE competition incentive fee were a complete success. As discused in the report, the procedures followed did not result in the PCO fully considering the effect of the Government's actions taken to increase competition in designing the competition incentive fee.

Last Paragraph (Cost Benefit Analysis). We did review the cost-benefit analysis mentioned in the Navy's comments. In determining the cost savings that occurred after contract award, the Navy analyst used sole source quotes instead of competitive quotes that were obtained on most of the major subcontracted items before contract award. In using the sole source quotes, the Navy analyst inflated the amount of competition savings achieved after contract award. In addition, the Navy analyst attributed all competition savings achieved to Litton's efforts without recognizing the effect of the Navy's $3.1 million investment in increasing competition both before and after contract award. As a result, we disagree with the Navy's conclusion that the analysis clearly demonstrated that the application of contract competition incentives saved the Navy $25.0 million over the first 3 production years. In our opinion, competition savings achieved should have been attributed, to a large extent, to the Navy's investment in increasing competition rather than to the application of contract competition incentives.

Matters of Concern, Contract Files

It is commendable that the Navy is taking action to improve the maintenance of the contract files. However, as of December 31, 1991, we did not see any evidence that improvements had occurred.

Matters of Concern, Contractor Claims

Special Tools and Test Equipment Claims. We commend the Navy for finalizing Litton's claimed special tools and test equipment costs in February 1991.

Foreign Military Sales Expense. We modified the report as suggested by the Navy.

Navy's Supplemental Comments, May 24, 1991

The Navy's plan to review the need to reemphasize or revise Navy guidance on the use of competition incentive fees, including the TAOC/MCE competition incentive fee example in the Navy Competition Handbook, is responsive to the implied recommendation in the report for the Navy to issue clarifying guidance if it intends to continue using competition incentive fees.

ACTIVITIES VISITED OR CONTACTED

Office of the Secretary of Defense

Office of the Under Secretary of Defense for Acquisition, Washington, DC
Office of the Assistant Secretary of Defense (Command, Control, Communications and Intelligence), Washington, DC
Office of the Director, Operational Test and Evaluation, Washington, DC

Department of the Navy

Office of the Assistant Secretary of the Navy (Research, Development and Acquisition), Washington, DC
Office of the Assistant Secretary of the Navy (Shipbuilding and Logistics), Washington, DC
Space and Naval Warfare Systems Command, Washington, DC
Marine Corps Research, Development and Acquisition Command, Arlington, VA
Tactical Air Operations Center/Modular Control Equipment Program Office, Washington, DC
Marine Corps Tactical Systems Support Activity, Camp Pendleton, CA
Marine Corps Operational Test and Evaluation Activity, Quantico, VA
Marine Corps Logistics Base, Albany, GA
Marine Air Control Squadron 1, Camp Pendleton, CA

Department of the Air Force

Office of the Assistant Secretary of the Air Force (Acquisition), Washington, DC
Air Force Systems Command, Andrews Air Force Base, MD
Tactical Air Command, Langley, VA
Air Force Electronics Systems Division, Hanscom Air Force Base, MA
Sacramento Air Logistics Command, Sacramento, CA
Tactical Air Warfare Center, Eglin Air Force Base, FL
3246th Test Wing, Eglin Air Force Base, FL

Other Defense Activities

Defense Contract Management Area of Operation, Colorado Springs Branch, Litton Data Systems, Colorado Springs, CO
Defense Plant Representative Office, Litton Data Systems, Woodland Hills, CA
Defense Contract Audit Agency, Sunnyvale, CA
Defense Contract Audit Agency, Van Nuys, CA

Contractors

Control Data Corporation, Minneapolis, MN
General Atronics, Philadelphia, PA
Gichner Shelter Systems, Dallastown, PA
Grumman Aerospace Corporation, Bethpage, NY
Harris Corporation, Rochester, NY
Litton Data Systems, Colorado Springs, CO
Litton Data Systems, Van Nuys, CA
Xetron Corporation, Cincinnati, OH

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Non-DoD Activities

Office of Management and Budget

U.S. General Accounting Office, NSIAD Technical Information Center

Congressional Committees:

- Senate Subcommittee on Defense, Committee on Appropriations
- Senate Committee on Armed Services
- Senate Committee on Governmental Affairs
- Senate Ranking Minority Member, Committee on Armed Services
- House Committee on Appropriations
- House Subcommittee on Defense, Committee on Appropriations
- House Ranking Minority Member, Committee on Appropriations
- House Committee on Armed Services
- House Committee on Government Operations
- House Subcommittee on Legislation and National Security, Committee on Government Operations

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