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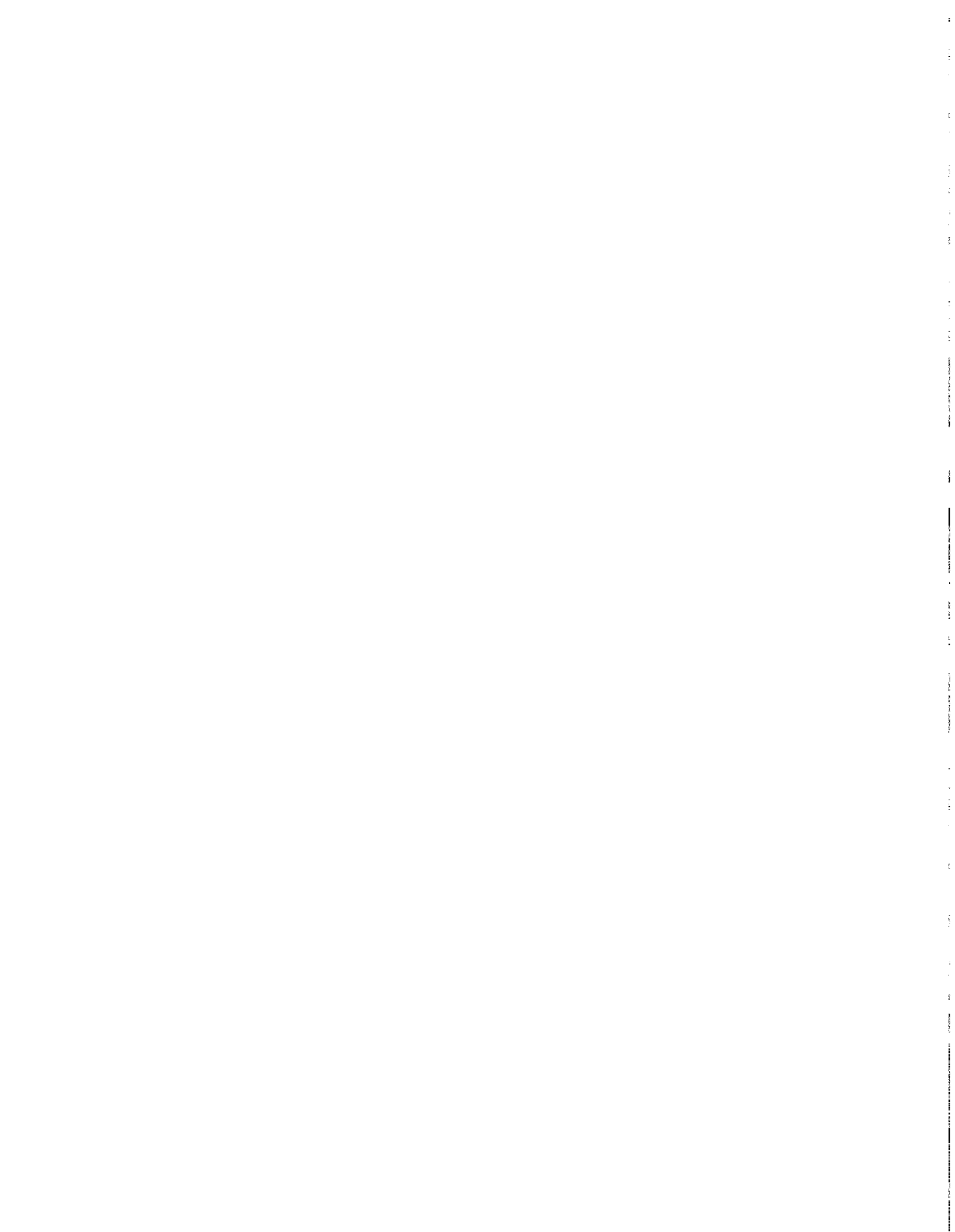
Report to the Honorable
William V. Roth, Jr., U.S. Senate

March 1991

CONTRACT PRICING

Opportunities to Reduce Dual-Source Contract Prices







United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-219741

March 28, 1991

The Honorable William V. Roth, Jr.
United States Senate

Dear Senator Roth:

This report contains the results of our review of six Department of Defense (DOD) dual-source contracts. Dual-source contracting anticipates that a government requirement will be split between two contractors, with the larger share usually going to the offeror submitting the lowest price.

This is the second report issued in response to your request that we determine whether contracting officers had sound bases for negotiating fair and reasonable prices in dual-source contracts. Earlier, we provided you the results of our review of eight other dual-source contracts.¹ In response to our earlier work, DOD has provided its contracting officers additional guidance for negotiating dual-source contract prices. The guidance is also discussed in this report.

Results in Brief

Contracting officers accepted the prices proposed on the six dual-source contracts we reviewed as fair and reasonable because they believed that adequate price competition existed. The contracting officers would have had a sound basis for reducing the prices of four of the contracts, which were awarded for about \$204.5 million, by about \$6 million had they obtained insight into the contractors' estimating methodologies, pricing strategies, and supporting cost information.

The other two contracts were awarded for about \$203 million. Insight into contractors' proposed prices would have disclosed competitive pricing and, as a result, contracting officers would have had a sound basis for awarding the contracts at the proposed prices without relying on pricing safeguards normally used in noncompetitive procurements.

DOD revised the Defense Federal Acquisition Regulation (DFAR) to instruct contracting officers to exercise deliberation and thorough review in making adequate price competition decisions on dual-source contracts. The revised regulation also instructs contracting officers to make such decisions on a case-by-case basis. The old regulation

¹Contract Pricing: Dual-Source Contract Prices (GAO/NSIAD-89-181, Sept. 26, 1989).

presumed that adequate price competition automatically existed on dual-source contracts and encouraged contracting officers to make dual-source awards on the basis of price analysis only.

Background

On competitive awards, contracting officers rely on a combination of a competitive marketplace and price analysis to ensure that the prices paid are fair and reasonable. Price analysis is the process of examining and evaluating a price without looking at the estimated cost elements and profit proposed by an offeror. Price analysis may involve comparing (1) one contractor's proposed price with a competing contractor's price, (2) proposed prices with government estimates, or (3) proposed prices with prices negotiated on prior contracts.

In the absence of competition, and where cost or pricing data are required, contracting officers rely on a number of safeguards to establish fair and reasonable prices and minimize the possibility of overpricing. For example, contracting officers normally rely on a team of experts, including auditors, price analysts, engineers, and production specialists to perform a cost and technical analysis of contractor proposals.

Contracting officers also have the Truth in Negotiations Act (P.L. 87-653, as amended) as a safeguard against inflated contractor cost estimates. The act was passed by the Congress in 1962 to protect the government against inflated contractor cost estimates by placing the government on an informational parity with contractors when negotiating noncompetitive contracts. The act, as amended, requires contractors, under specified circumstances, to submit cost or pricing data supporting proposed noncompetitive contract prices and to certify that the data submitted are accurate, complete, and current. If it is determined that the contract price is overstated because the data submitted were not accurate, complete, and current, the government has the right to reduce the contract price by the amount of the overstatement.

On noncompetitive contracts where cost or pricing data are required, a cost analysis is performed to evaluate the reasonableness of individual cost elements. Cost analysis differs from price analysis and involves an element-by-element examination of the estimated cost of contract performance, including cost or pricing data and judgmental factors applied in projecting estimated costs. It also involves analyzing design features,

materials, manufacturing processes, organization and manning, and estimating assumptions—all of which contribute to the total cost of a contract.

Cost analysis is used to establish the basis for negotiating contract prices when price competition is inadequate or lacking altogether, and when price analysis, by itself, does not ensure the reasonableness of prices. In short, cost analysis is used in the absence of adequate price competition to achieve what competition is presumed to achieve—a fair and reasonable price.

Contracting officers may also request a should-cost evaluation. Should cost is a specialized form of cost analysis that allows a more in-depth evaluation of a contractor's proposal. Should cost goes beyond reviewing historical costs and includes consideration of attaining additional economies and efficiencies in contractors' management and operations.

Contracting Officers Used Price Analysis to Evaluate Prices

On the six contracts we reviewed, DOD contracting officers relied on price analysis techniques to ensure that the proposed prices were fair and reasonable instead of obtaining insight into the proposed prices. Our review of contractors' cost-estimating methodologies and supporting cost information revealed that the contractors used both competitive and noncompetitive pricing techniques to develop the prices proposed on the six contracts. We found that contracting officers would have had a sound basis for seeking reductions in the prices of four of the six contracts, which were awarded for about \$204.5 million, by as much as \$6 million had they obtained insight into contractors' estimating methodologies, pricing strategies, and supporting cost information.

In one case, for example, the contractor used a competitive profit rate to develop its dual-source proposal. However, the resulting reduction was more than offset by noncompetitive pricing techniques such as inclusion of high material escalation costs and exclusion of anticipated vendor price reductions. Had insight into the contractor's pricing techniques been obtained, the contracting officer could have established a negotiation objective about \$3 million lower than what the company proposed.

In another case, the contractor used competitive pricing techniques in estimating the cost of material. For example, the contractor estimated vendor price reductions greater than historical data supported. However, the contractor proposed general and administrative expense rates

higher than the government recommendation and proposed a noncompetitive profit rate. These noncompetitive pricing techniques more than offset the competitive pricing techniques and resulted in a price about \$1.5 million more than the negotiation objective the contracting officer could have established had insight into the contractor's pricing techniques been obtained.

On the remaining two contracts, which were awarded for about \$203 million, we found that contractors' proposed prices were competitive. In these cases, insight into the contractors' estimating methodologies, pricing strategies, and supporting cost information would have provided contracting officers a sound basis for determining that competition existed and that there was no need to employ noncompetitive pricing safeguards.

DOD Regulations Revised to Provide Guidance to Contracting Officers

Our earlier report recommended that the Secretary of Defense direct appropriate personnel to revise the DFAR to provide contracting officers with guidance for determining when adequate price competition exists in dual-source contracts. We recommended that the guidance address the need for contracting officers to obtain a thorough understanding of contractors' proposed prices before making adequate price competition determinations. We said that such guidance would be consistent with the Assistant Secretary of Defense's (Procurement) recognition that adequate price competition determinations on dual-source procurements should be made with deliberation and thorough review.

We also said in our earlier report that the evaluations required to make adequate price competition determinations could be made without the intensive effort necessary to establish a negotiation objective. If such evaluations disclose competitive pricing, the contracting officer should presume that adequate price competition exists and award the contract. However, if the evaluation discloses noncompetitive pricing, the contracting officer should use the safeguards normally used to negotiate fair and reasonable noncompetitive contract prices.

Effective November 16, 1990, DOD revised its DFAR Supplement to emphasize that contracting officers need to make determinations of adequate price competition on dual-source contracts on a case-by-case basis. The revision requires contracting officers to exercise deliberation and thorough review in making such determinations. We support the revised DFAR guidance and believe that, if properly implemented, it should result in improved dual-source contract prices.

As requested, we did not obtain agency comments. However, we discussed the contents with DOD and contractor officials and incorporated their comments where appropriate. We also excluded contractor proprietary data from the report. Our scope and methodology are discussed in appendix I.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time we will send copies to the Secretaries of Defense, Air Force, Army, and Navy; the Director, Office of Management and Budget; and interested congressional committees. Copies will also be made available to others on request.

Please contact me at (202) 275-8400 if you or your staff have any questions concerning this report. Other major contributors to this report are listed in appendix II.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Paul F. Math". The signature is stylized with a large, sweeping initial "P" and a distinct "M".

Paul F. Math
Director, Research, Development,
Acquisition, and Procurement Issues

Scope and Methodology

We reviewed six dual-source contracts awarded to six major defense contractors involving the three weapon systems. (See table I.1.)

Table I.1: Dual-Source Weapon Systems and Contractors

Systems	Contractors
Standard Missile-2	General Dynamics Corporation, Pomona, California, and Raytheon Company, Bristol, Tennessee
Sidewinder (AIM-9M)	Raytheon Company, Lowell, Massachusetts, and Ford Aerospace Corporation, Newport Beach, California
Countermeasures Warning System (AN/ALR-67)	General Instrument Corporation, Belmont, California, and Litton Systems, Inc., San Jose, California

To assess whether contracting officers had a sound basis for negotiating fair and reasonable dual-source contract prices, we evaluated contractors' estimating methodologies, pricing strategies, and supporting cost information to determine whether competitive pricing techniques were employed in developing the proposed dual-source contract prices. We analyzed material, labor, and indirect cost information supporting the contractors' proposed prices. We compared contractor proposed labor and overhead rates for dual-source awards to rates that were recommended by cognizant DOD contract administration agencies at the time the dual-source contracts were awarded. We also compared proposed material prices with contractors' supporting cost information.

For purposes of our review, we defined competitive pricing techniques as those that produced prices equal to or less than the negotiation objectives that contracting officers could have established through use of the safeguards normally used on noncompetitive contracts. Conversely, we defined noncompetitive pricing techniques as those that produced prices higher than the negotiation objectives, which contracting officers could have established.

We determined the negotiation objectives by using the same type of pricing information that contracting officers have available for negotiating noncompetitive contracts. For example, we used the labor and indirect expense rates recommended by cognizant government contract administration agencies when the dual-source contracts were awarded. We also used the latest material pricing information available to the contractors. In those cases where we found contractors did not use accurate, complete, and current cost information, we assumed a Defense

Contract Audit Agency review would have identified the condition and recommended a reduction in proposed prices.

In addition to performing work at the contractor locations listed in table I.1, we also obtained data from and interviewed officials from the Naval Air and Sea Systems Commands, Crystal City, Virginia, and the resident Defense Contract Audit Agency and cognizant defense contract administration services agencies. We also reviewed various government contract documents, including proposal solicitations, negotiation memorandums, technical reports, and other records related to dual-source and noncompetitive procurements.

Our review was performed from May 1989 to February 1991 in accordance with generally accepted government auditing standards.

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