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# Questionable Pricing Of Traveling-Wave Tubes On The Basis Of Catalog Prices<sub>8-162180</sub>

Department of Defense

*UNITED STATES  
GENERAL ACCOUNTING OFFICE*

13-162180

OCT. 19, 1970



# UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

DEFENSE DIVISION

B-162180

Dear Mr. Secretary:

This is our report on questionable pricing of traveling-wave tubes on the basis of catalog prices. The significant contents of the report are summarized in the digest which is bound in the report.

Our review was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53); the Accounting and Auditing Act of 1950 (31 U.S.C. 67); and the authority of the Comptroller General to examine contractors' records, as set forth in contract clauses prescribed by the United States Code (10 U.S.C. 2313(b)).

The contract discussed in this report was mentioned in our report to the Congress on "Improvements Needed in Negotiating Prices of Non-competitive Contracts Over \$100,000 on the Basis of Contractors' Catalog or Market Prices" (B-39995, December 3, 1969). It was used in that report as an example of catalog pricing where no individual sale to a commercial customer had been made for quantities comparable to those purchased by the Government under a single procurement. We stated that the commercial sales did not appear to provide a basis for accepting a catalog or market price for the contract. We performed the current review to determine whether the contract price was reasonable in relation to available cost information.

We are aware that the Armed Services Procurement Regulation Committee is considering a revision which would furnish guidance for accepting catalog prices for items where commercial sales similar to the proposed purchase by the Government have not been made. We believe that the findings in this report confirm the need for such guidance.

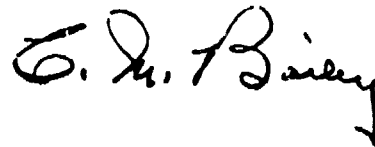
Copies of this report are being sent to the Director, Office of Management and Budget; the Secretary of the Army; the President, Watkins-Johnson Company; the Headquarters Office, Defense Contract Audit

B-162180

Agency; and the Regional Manager, San Francisco Region, Defense Contract Audit Agency.

We shall appreciate being advised of the results of actions taken on this report.

Sincerely yours,

A handwritten signature in cursive script that reads "E. M. Bailey". The signature is written in black ink and is positioned above the typed name.

Director, Defense Division

The Honorable  
The Secretary of Defense

D I G E S T

WHY THE REVIEW WAS MADE

The General Accounting Office (GAO) has examined into the pricing of a sole-source firm-fixed-price contract for traveling-wave tubes awarded to Watkins-Johnson Company, Palo Alto, California, by the U.S. Army Northwest Procurement Agency, Oakland, California. The tubes were needed for use in the NIKE-HERCULES missile system.

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In view of GAO's conclusion that this procurement should not have been exempted from the requirements of Public Law 87-653 for submission of cost or pricing data, GAO wanted to find out whether the negotiated price was reasonable in relation to available cost information.

FINDINGS AND CONCLUSIONS

GAO reviewed the records related to contract DAAG 05-67-C-0799 which had been awarded for the procurement of 500 traveling-wave tubes valued at \$1.269 million. The Government requested cost or pricing data; however, the contractor refused to furnish the data and, instead, represented that (1) the item was part of a product line sold in substantial quantities to the general public and (2) the price charged was no higher than that charged to the most favored customers. Contract negotiations were concluded by the Government's accepting the price on the basis of the contractor's representations.

GAO found that the contractor had not sold the contracted item in substantial or comparable quantities to the general public. Although the contractor had made substantial commercial sales of other items in the product line, GAO believes that such sales do not provide a valid basis for accepting a catalog price for the contracted item. Under these circumstances the Government should have been furnished cost or pricing

data in support of the proposed and negotiated price of \$1.269 million. Had the contractor furnished cost or pricing data, the data would have shown that the proposed contract price exceeded current costs by about 100 percent, or about \$632,000. By using the current cost data and allowing the contractor its usual proposed profit on non-catalog-priced items, the Government would have saved \$536,000.

Also, GAO found that the contractor gave the Government a 30-percent discount from its catalog price but had given another customer a 37-percent discount on procurement of a lesser quantity of a similar tube. Had the contractor given the Government the most-favored-customer price, catalog price less 37 percent, the contract price would have been reduced by about \$122,000.

### RECOMMENDATIONS OR SUGGESTIONS

GAO is recommending that the Department of Defense consider:

- The findings in the report in the light of whether the contractor's representations of substantial commercial sales of a product line and the most-favored-customer price to the Government provide a legal basis for a price adjustment.
- The implementation of the recommendations in GAO's report to the Congress. GAO recommended in that report that the Secretary of Defense provide more definite criteria for defining substantial sales to the general public so that there would be more uniform determinations that products meet the standards of catalog pricing and the exemption under Public Law 87-653 which requires submission of certified cost or pricing data. GAO recommended also that Defense regulations be revised to require contracting officials, in determining whether catalog prices may be accepted, to give appropriate consideration to the relative quantities in individual commercial sales and in sales to the Government.

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## C o n t e n t s

	<u>Page</u>
DIGEST	1
CHAPTER	
1 INTRODUCTION	3
Catalog pricing	3
Contract negotiations	4
2 INAPPROPRIATE ACCEPTANCE OF PRICE BASED ON CATALOG INSTEAD OF COST OR PRICING DATA	6
No substantial or comparable quantities of contract item sold to the general public	9
Catalog pricing of contract item based on commercial sales of other items	9
Prices negotiated higher than indicated by available cost or pricing data	10
3 QUANTITY DISCOUNT TO THE GOVERNMENT LOWER THAN TO MOST FAVORED CUSTOMER	13
4 CONCLUSIONS AND RECOMMENDATIONS	16
Conclusions	16
Recommendations	17

### ABBREVIATIONS

ASPR	Armed Services Procurement Regulation
DCAA	Defense Contract Audit Agency
GAO	General Accounting Office

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## CHAPTER 1

### INTRODUCTION

The General Accounting Office has reviewed the pricing of 500 traveling-wave tubes purchased on a sole-source basis under negotiated contract DAAG 05-67-C-0799, dated March 17, 1967, in the amount of \$1.269 million. The contract was awarded by the U.S. Army Northwest Procurement Agency, Oakland, California, to Watkins-Johnson Company, Palo Alto, California.

Watkins-Johnson Company was organized in December 1957 to engage in research, development, and production of advanced electronic devices and related systems and equipment. The contractor employed about 1,100 people at the end of 1969 at three locations--Stanford Industrial Park, Palo Alto, California; Santa Cruz, California; and Rockville, Maryland. Sales in 1969 were about \$31 million and in 1968 were about \$37 million. The contractor uses a type of cost system in which input costs are accumulated on an actual cost basis for a family of related products. The tube purchased under the negotiated contract -0799 is a member of a traveling-wave tube family consisting of the types 269, 281, 329, and 355.

The price negotiated was based on a catalog price of an item that the contractor represented as part of a product line sold in substantial quantities to the general public and therefore exempt from the cost or pricing data requirements of Public Law 87-653.

In our review we evaluated (1) the validity of the contractor's representation and the Government's determination that cost or pricing data were not required and (2) the reasonableness of the negotiated price in relation to cost or pricing data and other information available to the contractor prior to contract negotiations.

### CATALOG PRICING

Public Law 87-653 provides that, with certain exceptions, contractors be required to submit cost or pricing data and a certificate regarding the accuracy, currency,

and completeness of such data prior to award of any negotiated contract or subcontract expected to exceed \$100,000. One of the exceptions permits the award of negotiated contracts without submission of certified cost or pricing data whenever the proposed price is based on an established catalog or market price of a commercial item sold in substantial quantities to the general public.

The exception to the requirement for cost or pricing data for such catalog-priced noncompetitive contracts was included in the Armed Services Procurement Regulation (ASPR) prior to enactment of Public Law 87-653. The rationale for this exception was that many buyers, having repeatedly shown a readiness to purchase an item at a certain price, indicated by their actions that the price was set by the forces of the market. Therefore, the price may properly be assumed to be fair if price analysis, not cost analysis, shows it to be reasonable.

#### CONTRACT NEGOTIATIONS

On January 26, 1967, the U.S. Army Northwest Procurement Agency and the contractor executed letter contract DAAG 05-67-C-0799 for the manufacture of 500 type 269 tubes. The letter contract provided that the contractor furnish cost or pricing data. On February 1, 1967, the contractor submitted a firm proposal to furnish the 500 tubes valued at \$1.269 million, or \$2,538 per unit, and a statement that the item purchased was part of a product line sold in substantial quantities to the general public. Contract negotiations were concluded on February 24, 1967 by the Government's accepting the price on the basis of a determination by the contracting officer that the contract item met the criteria set forth in Defense regulations for an item sold in substantial quantities to the general public. Letter contract -0799 was definitized on March 17, 1967, for 500 tubes at the amounts proposed by the contractor.

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The contract discussed in this report was mentioned on page 19 in our report to the Congress. It was used as an example of catalog pricing where no individual sale to a commercial customer had been made for quantities comparable

to those purchased by the Government under a single procurement. We stated that under these circumstances it did not appear that the commercial sales provided a basis for accepting a catalog price for contract -0799. At the time of our review, we requested access to the contractor's cost records to see what the price might have been had negotiation been conducted on the basis of cost or pricing data available at the time of negotiation and whether the contract price was reasonable in relation to the actual costs. The contractor initially refused to allow us to examine all records necessary to ascertain the costs for the items purchased under contract -0799. After several demands by our office and a long delay, however, the contractor agreed to our right under the examination-of-records clause and made all pertinent records available to us.

## CHAPTER 2

### INAPPROPRIATE ACCEPTANCE OF PRICE BASED ON CATALOG INSTEAD OF COST OR PRICING DATA

Watkins-Johnson declined to furnish to Government negotiators cost or pricing data to support the contract price, because the item being procured was part of a product line sold in substantial quantities to the general public.

Our review showed that the contract item had not been sold in substantial or comparable quantities to the general public. In our opinion sales of other items in the product line at catalog or market prices did not provide a basis for establishing the price of the traveling-wave tubes which were being purchased under contract -0799. Under these circumstances, the contracting officer should not have exempted the contract item from the requirement for submitting cost or pricing data.

Had available cost information been obtained, it would have shown that the contract costs could not reasonably be expected to exceed about \$637,000. Allowing the contractor its usual proposed profit rate of 15 percent on non-catalog-priced items, the price to the Government would amount to \$732,500 instead of \$1,269,000, a difference of about \$536,000.

In December 1966 the U.S. Army Missile Command formally approved noncompetitive procurement of 500 NIKE-HERCULES-LOPAR traveling-wave tubes from Watkins-Johnson. The Command justified noncompetitive procurement, because the requirement was for a new product for which drawings and specifications were not available. Watkins-Johnson was designated by the Command as the only source possessing the technical and managerial know-how to produce and deliver the tubes within the time required. The U.S. Army Northwest Procurement Agency was designated as the purchasing office.

On January 12, 1967, in response to a telephone request by the Agency, the contractor submitted a price proposal for 500 type 269-20 traveling-wave tubes at \$1.269 million, or \$2,538 each. Because of the extreme urgency of the

requirement, the Agency and the company executed letter contract DAAG 05-67-C-0799 on January 26, 1967. The letter contract provided that, prior to definitizing the contract, the company submit a firm quotation supported by a cost breakdown, together with a "Certificate of Current Cost and Pricing Data." The letter contract provided also that a "price reduction for defective cost or pricing data" clause, would be included in the contract. On January 27, 1967, the contractor informed the Agency that:

"In the negotiation for the formal contract, we would expect that no cost breakdown or Certificate of Current Cost or Pricing Data will be required since this item is a minor modification of a standard catalog item, the WJ-269, which is listed on our price lists which are regularly maintained, published, or otherwise made available for inspection by customers and which state prices at which sales are currently made to a significant number of buyers constituting the general public. This tube type is part of our product line which is regularly used for other than government purposes, is sold in the course of conducting normal business operations, is sold regularly in quantities sufficient to constitute a real commercial market, and is sold to other than our affiliates for end use by other than the Government." (Underscoring supplied.)

On February 1, 1967, the contractor submitted its firm quotation for 500 type 269-20 tubes at \$2,538 each. In addition, the contractor reiterated its previous demand that:

"Prior to any negotiations on the formal contract, Watkins-Johnson must have your assurance that no cost breakdown or Certificate of Current Cost or Pricing Data will be required in the definitized contract or by the subject letter contract.

"If this assurance is not received by Watkins-Johnson, in writing, within seven (7) days from today's date, Watkins-Johnson shall cease all work on this letter contract, until and unless this matter is resolved without the requirement

for a cost breakdown or Certificate of Current Cost or Pricing Data. A corresponding day-to-day slippage in delivery schedule will result."

At a meeting held at the Agency on February 15, 1967, Government officials asked the contractor to rescind the January 27, 1967, letter. Contractor officials refused and stated that this point could not be negotiated. Instead, the contractor, on February 20, 1967, furnished the Agency with

- a price breakdown in support of certain modification costs of \$106 a unit,
- a price list showing prices for low-power microwave tubes,
- a breakdown of nonrenegotiable sales of these tubes indicating that 30.5 percent of all 1965 sales and 31.86 percent of all 1966 sales were not subject to renegotiation, and
- a statement that the tube purchased was a part of a product line sold in substantial quantities to the general public and that the price proposed was no higher than that charged to its most favored customer for like quantities.

The Agency made an analysis of the \$106 modification costs; also it requested the Defense Contract Audit Agency (DCAA) to independently verify the company's representation in support of the catalog price and to obtain cost and pricing data. The contractor refused to make available cost or pricing data. DCAA's response indicated that the contractor did not make available any information on commercial sales of the type 269-20 tube and that 28.6 percent of its sales of the low-power microwave tubes for 1965 were commercial.

On the basis of the data submitted and the contractor's attitude not to accede to the demands for cost or pricing data, the Agency informed the contractor on February 24, 1967, that the Government accepted the contractor's position that the item was a commercial item sold in substantial quantities to the general public.

NO SUBSTANTIAL OR COMPARABLE QUANTITIES OF  
CONTRACT ITEM SOLD TO THE GENERAL PUBLIC

Our review showed that in 1966 sales of the 269 family, consisting of four similar traveling-wave tubes, totaled 284 units. Of this quantity, 239 were sold to the U.S. Government, 24 to commercial customers, 19 to foreign Governments, and two to universities.

On this basis about 84 percent of the total was not sold to the general public and it seems unlikely that this sales experience could support a determination by agency officials to negotiate on the basis of the catalog price. Further, as noted in our report of December 3, 1969, the largest individual commercial sale during 1965 and 1966 had been for five traveling-wave tubes compared with 500 to be purchased by the Government under a single order.

Under these circumstances, the existence of commercial sales of the item did not appear to provide a basis for accepting a catalog price for contract -0799.

CATALOG PRICING OF CONTRACT ITEM BASED  
ON COMMERCIAL SALES OF OTHER ITEMS

In support of its representation that the 269-20 tube was part of a product line sold in substantial quantities to the general public, the contractor submitted a list of about 165 types of low-powered microwave tubes showing quantities sold to commercial customers in 1965 and 1966. The contractor stated that these quantities of commercial sales represented 30.5 percent and 31.86 percent of total sales for these years. The total sales of these tubes for each year were not submitted.

The contractor justified its use of a product line to show substantial sales on the basis that:

- All tubes listed were low-powered microwave consisting of traveling-wave tubes and backward-wave oscillators, similar in mechanical design, being constructed of glass envelopes and components, focused by magnetic structures, and packaged in a metal container.

--The price of an individual low-power microwave tube depends on the complexity of the design, the frequency range, the power output, the noise level, and other technical requirements which vary according to the customer's needs and which can have a substantial effect upon manufacturing costs.

The contractor represented that the commercial nature of the sales was substantiated by the fact that none of the sales were subject to renegotiation.

The catalog prices for the types of tubes listed ranged from \$800 to \$6,900 a unit. The wide differences in unit prices indicated that the types of tubes were significantly dissimilar in either cost of production or customer willingness to buy at the market price. The total number of units listed as commercial for 1966 amounted to 3,930 units. Our review showed that sales of eight of the 165 types of tubes accounted for 54 percent of the commercial sales. The prices of these types of tubes ranged from \$604 to \$841 a unit. The unit price of the 269 tube was \$2,538.

In view of the wide differences in unit prices, there appears to be no sound reason for accepting the 269-tube price as a market-tested price on the basis of substantial commercial sales of the other types of tubes.

Our limited tests of the sales of other than the 269 family of tubes showed that their classification as commercial sales was questionable. The sales were made to contractors holding defense contracts and the purchase orders specified that the sales were subject to the Renegotiation Act and thus appeared to be for Government end use.

PRICES NEGOTIATED HIGHER THAN INDICATED  
BY AVAILABLE COST OR PRICING DATA

Since we concluded that the proposed procurement was not exempt from the cost or pricing data requirements of Public Law 87-653 and implementing regulations, we wanted to find out whether lower prices should have been negotiated if cost or pricing data had been obtained. Our examination of the costs of production of the family of 269-type traveling-wave tubes that were available if catalog pricing



had not been accepted indicated that negotiation on the basis of cost or pricing data should have resulted in a price reduction of about \$536,000, or 42 percent.

A traveling-wave tube consists of two basic components, namely, the power supply and the tube. The contractor's accounting system for these products provides for the accumulation of costs by specific tube-type families. The 269 tube family consists of types 269, 281, 329, and 355. This family is manufactured by the company on the same production line and a job-type cost system is used to accumulate actual costs.

Had the contractor agreed to submit cost or pricing data for the negotiation of contract -0799 and had it not insisted on catalog pricing, the costs to manufacture the 269 tube family for the period January 1 through February 24, 1967, would have been available for the Government to review in March 1967. These costs plus a 15-percent profit, the rate the contractor normally requested on non-catalog firm-fixed-price contracts, would have amounted to a price of \$733,000 instead of \$1,269,000, as shown below:

	<u>Unit price</u>	<u>Price for 500 Tubes</u>
Contract price	<u>\$2,538</u>	<u>\$1,269,000</u>
Costs as of 2-24-67 (note a):		
Power supply	505	
Tube	<u>770</u>	
	1,275	637,500
Profit--15 percent	<u>191</u>	<u>95,500</u>
Price based on cost data	<u>\$1,466</u>	<u>\$ 733,000</u>
Difference	<u>\$1,072</u>	<u>\$ 536,000</u>

<sup>a</sup>Based on overhead rate of 180.13 percent and general and administrative rate of 23.86 percent.

In performing the contract during the period March through July 1967, the contractor's unit cost for the 269 tube family averaged \$1,162. On this basis, costs for 500 units under contract -0799 totaled \$581,000 and the price of \$1,269,000 exceeded costs by \$688,000, or about 118 percent.

### CHAPTER 3

#### QUANTITY DISCOUNT TO THE GOVERNMENT

#### LOWER THAN TO MOST FAVORED CUSTOMER

Since the contractor's proposed and negotiated price for contract -0799 was based on its catalog price less a quantity discount of 30 percent, we reviewed the reasonableness of the pricing on this basis. The contractor had represented that the price to the Government for the 269 tube was no higher than that charged to its most favored customers for like quantities. We found, however, that, on previous sales to another customer of other tubes in the product line, listed at the same catalog price as the 269 tube, the contractor had allowed a discount of about 37 percent for fewer units. Had this higher discount been allowed the Government on contract -0799, the price would have been reduced by about \$122,000.

By letter of February 20, 1967, the contractor informed the Northwest Procurement Agency that the item produced was part of its product line of low-power microwave tubes that were sold in substantial quantities to the general public. In this letter the company also certified that the proposed unit price of \$2,538 was not higher than that charged to its most favored customers for like quantities and that the derivation of the 269-tube price was as follows:

Catalog price of WJ-269 tube		\$3,500
Less:		
Warranty	\$ 25	
Quantity discount--30 percent	<u>1,043</u>	<u>1,068</u>
		2,432
Minor modification		<u>106</u>
		<u>\$2,538</u>

The contract specialist for the Northwest Procurement Agency attempted to verify the contractor's proposed discount but was told by the company that no price schedules for quantity discounts were available and that sales of this family of tubes were not normally made in large quantities. The contracting officer in his summary of negotiations indicated reliance on the company's representation in support of the 30-percent quantity discount.

We found that the contractor had sold quantities of several types of low-power microwave tubes to another company at a discount of about 37 percent of the catalog price. These tubes were included in the product line listing furnished to the Government. The sales were made from May 1966 to March 1967 at quantities ranging up to 180 tubes.<sup>1</sup> The catalog prices for these other tubes were also \$3,500 a unit, but sales were made at about \$2,200 a unit, a discount of 37 percent. The company offered the discount because of efficiencies resulting from quantity production.

It appeared that the contractor had no formal pricing schedule establishing quantity discounts. The contractor's records, however, showed that discounts had been offered to another customer for quantities of less than 500 units. Had the contractor disclosed this information, the contracting officer should have recognized that the Government was not receiving the most-favored-customer price as represented by the contractor.

As shown on pages 7 and 8, the contractor insisted that all low-power microwave tubes it produced should be considered as one product line and the sales of this product line should be the basis for determining whether there had been substantial sales to the general public. The contracting officer ultimately accepted the contractor's position that there had been substantial commercial sales of the product line and negotiated the contract price based on the catalog price less 30-percent discount.

Since the entire product line was accepted for determining substantial commercial sales, it should also have

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<sup>1</sup>Types 294, 295, 296, 297.

been used to determine the highest discount the Government should receive in accordance with the contractor's representation that the proposed price was no higher than that charged its most favored customer for like quantities. On the basis of a 37-percent discount, the unit price of the 269 tube would have been reduced by \$243 and the price of contract -0799 by \$122,000, as shown below.

Price based on 30-percent discount (see p. 13)			\$ 2,538
Price based on 37-percent discount:			
Catalog price		\$3,500	
Less:			
Warranty	\$ 25		
Discount	<u>1,286</u>	<u>1,311</u>	
		2,189	
Minor modification		<u>106</u>	
		2,295	<u>2,295</u>
Difference			\$ <u>243</u>
Price reduction for 500 units (rounded)			\$122,000

## CHAPTER 4

### CONCLUSIONS AND RECOMMENDATIONS

#### CONCLUSIONS

We believe that the price negotiated for contract -0799 should not have been based on a catalog price. The contractor's insistence on using a product line consisting of about 165 types of tubes with widely varying unit prices to establish substantial commercial sales was not reasonable. This method did not establish that the catalog prices of the contract items had been accepted, or market tested, by substantial sales to the general public. It should not have been accepted by the contracting officer.

In our opinion sales to the general public of the contract item were neither substantial nor comparable to the quantities to be purchased by the Government. Under these circumstances, the contracting officer should not have determined that catalog pricing was justified and that the procurement was exempt from the cost- or pricing-data requirements of Public Law 87-653. In view of the contractor's adamant position in refusing to submit such data, the contracting officer should have referred this procurement to higher echelons of the Department of the Army.

Our review showed that, had the Army been successful in requiring the contractor to submit cost or pricing data, such data would have provided a sound basis for negotiating a price \$536,000 lower than the \$1,269,000 accepted on the basis of a catalog price.

We believe also that the contractor's price to the Government, based on its catalog price for the contract items, was not the most-favored-customer price. The contracting officer relied on the contractor's representation and accepted the catalog price less a 30-percent quantity discount. We found that items in the same product line had been sold to another customer in smaller quantities at the same catalog price less a quantity discount of 37 percent. Had the Government received the most-favored-customer quantity discount and had no cost and pricing data been

submitted, the contract price would have been reduced by about \$122,000.

In our report to the Congress, we noted the actions being considered by the Department of Defense to improve its policies and practices with regard to catalog pricing. We recommended in that report that the Secretary of Defense provide more definite criteria for defining substantial sales so that there would be more uniform determinations that products meet the standards of catalog pricing and the exemption under Public Law 87-653 for submission of certified cost or pricing data. We recommended also that Defense regulations be revised to require contracting officials, in determining whether catalog prices may be accepted, to give appropriate consideration to the relative quantities in individual commercial sales and in sales to the Government.

By letter dated December 30, 1969, we commented on the proposed actions being considered by the Department of Defense. We stated that these actions did not provide guidance to contracting officials for determinations of substantial sales to the general public and of relative quantities of commercial and Government sales--the more significant deficiencies in the administration of the catalog-price exemption.

We believe that this report illustrates the need for such guidance and the increased cost to the Government resulting from inadequate policies and practices relating to catalog pricing.

### RECOMMENDATIONS

GAO recommends that the Department of Defense consider:

- The findings in the report in the light of whether the contractor's representations of substantial commercial sales of a product line and the most-favored-customer price to the Government provide a legal basis for a price adjustment.
- The implementation of the recommendations in our report to the Congress.