093099

UNITED STATES GENERAL ACCOUNTING OFFICE
REGIONAL OFFICE
ROOM 1903 JOHN F. KENNEDY FEDERAL BUILDING
GOVERNMENT CENTER
BOSTON, MASSACHUSETTS 02203

093099

October 17, 1974

Vice Admiral R. C. Gooding, USN
Commander, Naval Sea Systems Command
Department of the Navy
Washington, D.C. 20362

Dear Admiral Gooding:

The General Accounting Office is performing a broad examination of the reasonableness of noncompetitive prime contract prices negotiated under the provisions of Public Law 87-653. As part of this examination, we have reviewed four subcontracts awarded to General Electric Company (GE) by Newport News Shipbuilding and Dry Dock Company (Newport News) under prime contract N00024-70-C-0252, dated February 5, 1970. Effective December 21, 1971, the contract awarded by the Naval Ship Systems Command, now the Naval Sea Systems Command, was converted from a cost plus fixed fee (CPFF) to a fixed-price-incentive (FPI) contract, with a sharing ratio of 80/20, a target price of $254.8 million, and a ceiling price of $300 million. The contract provides for the construction of three nuclear powered guided missile frigates, the DLG(N)'s 38, 39 and 40.

Following is data on the subcontracts (purchase orders) we reviewed.

Date	Number	Item	Fixed Price
6-14-71	601H-4000-E-1 Mod. #5	Turbine generators for DLG(N) 39	$3,015,000
10-6-71	601H-6100-M1 Mod. #5	Main propulsion units for DLG(N) 39	$2,829,330
1-21-72	601H-6100-M1 Mod. #7	Main propulsion units for DLG(N) 40	$3,027,380
2-25-72	601H-4000-E-1 Mod. #11	Turbine generators for DLG(N) 40	$3,204,000

The objective of our review was to find out whether the subcontract amounts included in the prime contractor's proposal were reasonable in relation to subcontractor cost or pricing data available at the time of prime contract negotiations.

Our review disclosed that the target cost of the prime contract was about $367,000 higher than indicated by available cost or pricing data because the contracting officer:

--granted his consent to Newport News to procure the main propulsion units and turbine generators without requiring Newport News to submit supporting subcontractor cost or pricing data as required by the terms of the prime contract.

--during subsequent prime contract negotiations, did not require Newport News to support subcontract estimates of $1 million or more with cost or pricing data as required by the Armed Services Procurement Regulation (ASPR).

--did not use Defense Contract Audit Agency (DCAA) audit reports to require Newport News to reduce subcontract prices even though: (a) DCAA reported that the prices were excessive, and (b) any subcontract price reduction would benefit the Government because of the cost reimbursable features of the prime contract.

We also found that no action had been taken on the subcontractor's offer to reduce its price based on the results of a DCAA defective pricing review.

OVERPRICING OF SUBCONTRACTS

Turbine generators for the DLG(N)'s 39 and 40

The following schedule shows the overpricing by element of the turbine generators.

Element	DLG(N) 39	DLG(N) 40	Total
Direct Labor	$10,293	$14,085	$ 24,378
Indirect Manufacturing Expense	37,429	48,908	86,337
Product Engineering Cost and Expense	6,347	8,378	14,725
General and Administrative Expense	8,597	11,348	19,945
Total Costs	$62,666	$82,719	$145,385
Profit	12,164	16,056	28,220
Total Price	$74,830	$98,775	$173,605

GE's proposal for the DLG(N) 40 generators was based on the same costs as for the DLG(N) 39, escalated to the year of delivery. Accordingly, the following discussion of the DLG(N) 39 overpricing applies to the DLG(N) 40.

Direct Labor

The proposed hourly rates for assembly and pipe labor and for test labor were based on hourly wage increases of 33 and 36 cents, respectively, anticipated to occur after the scheduled delivery date. In addition, the proposed assembly and pipe labor hours and test labor hours were 612 and 702 hours higher, respectively, than indicated by actual experience.

A further analysis of the $10,293 overpricing of direct labor follows:

	Assembly & Pipe Labor	Test Labor	Total
Overstated hours:			
612 x $4.59 (Proposed rate)	$2,809		
702 x $4.81 (Proposed rate)		$3,377	
Overstated rate:			
$.33 x 8,190 (Adjusted hours)	2,703		
$.36 x 3,900 (Adjusted hours)		1,404	
Total	$5,512	$4,781	$10,293

Indirect Manufacturing Expense (IME)

The proposed IME pool included transportation costs for the generators; whereas, the purchase order provides for shipment F.O.B. GE's plant. These costs represent 5 percent of the proposed IME rate of 291 percent. Following is the computation of the overstated IME.

5% x $159,756 (Proposed total labor)	$ 7,988
286% x $10,293 (Overstated labor)	29,441
Total	$37,429

BEST DOCUMENT AVAILABLE

Product Engineering
Cost and Expense (PEC&E)

The $6,347 overstated PEC&E was computed by applying the proposed PEC&E's rate of 13.3 percent to the overstated direct labor and IME costs of $47,722.

General and Administrative
Expense (G&A)

The $8,597 overstated G&A was computed by applying the proposed G&A rate of 15.9 percent to the overstated direct labor, IME and PEC&E costs of $54,069.

Profit

The overstated profit of $12,164 was computed by applying the proposed profit rate of 19.41 percent to the total overstated costs of $62,666.

Main propulsion units for
the DLG(N)'s 39 and 40

The following schedule shows the overpricing by element of the main propulsion units.

Element	DLG(N) 39	DLG(N) 40	Total
Material	$ 6,064	$ 6,064	$ 12,128
Indirect Manufacturing Expense	45,277	47,993	93,270
Engineering	4,005	4,216	8,221
Complaints	1,027	1,081	2,108
General and Administrative Expense	18,540	19,579	38,119
Transportation	8,537	9,248	17,785
Total Costs	$83,450	$88,181	$171,631
Profit	10,006	11,746	21,752
Total Price	$93,456	$99,927	$193,383

GE's proposed costs for main propulsion units for the DLG(N)'s 39 and 40 were based on the same costs escalated to the year of delivery. Therefore, the following explanation of the overpricing of the DLG(N) 39 also applies to the DLG(N) 40.

Material

The proposed cost for two valve chest covers was $13,840, whereas the cost of the latest purchase for two of this same item was $7,776; a difference of $6,064.

Indirect Manufacturing
Expense (IME)

The proposed IME pool included $898,200 of costs unallowable under ASPR XV, overstated depreciation, and a mathematical error in the computation of an overhead rate for items transferred from one department to another. These overstated costs represent 9 percent of the IME rate of 222 percent. GE's total proposed direct labor cost was $503,073, and 9 percent of that amount is $45,277.

Engineering

The overstated engineering costs of $4,005 was computed by applying the proposed engineering rate of 7.8 percent to the overstated material and IME costs of $51,341.

Complaints

The overstated complaints costs of $1,027 was computed by applying the proposed complaint rate of 2 percent to the overstated material and IME costs of $51,341.

General and Administrative
Expense (G&A)

The proposed G&A pool included $188,028 of sales promotion, advertising and other costs unallowable under ASPR XV. These unallowable costs represent .59 percent of the proposed G&A rate of 9.5 percent. The overstated G&A costs of $18,540 was computed as follows:

.59% x $2,291,095 (Proposed manufacturing costs)	$13,517
8.91% x $56,373 (Overstated manufacturing costs)	5,023
Total	$18,540

Transportation

Transportation costs were proposed at $17,755, whereas actual costs incurred on a prior ship plus escalation to the year of delivery amounts to $9,218, a difference of $8,537.

Profit

The overstated profit of $10,006 was computed by applying the proposed profit rate of 11.99 percent to the total overstated costs of $83,450.

- - - - - - -

DCAA performed a defective pricing review of GE's proposal for the turbine generators for the DLG(N) 39. In a letter dated November 2, 1973, the contracting officer set forth his reasons to DCAA for not sustaining its findings. His reasons are:

--The target price negotiated was based on a total target cost and profit without attempting to get agreement on specific cost elements.

--The great difference in price submitted by Newport News and the final negotiated price.

--The updated data would have no effect on the negotiated price.

We do not believe that his position is valid because the prime contract is a FPI contract which provides that the Government reimburse the prime contractor for costs incurred up to a stipulated amount. Therefore, it is in the Government's interest that the prime contractor not incur unnecessary costs such as overpriced subcontracts.

CONSENT GRANTED TO SUBCONTRACT
FOR DLG(N) 39 and 40 EQUIPMENT
WITHOUT OBTAINING COST OR PRICING DATA

Effective February 5, 1970, the Naval Ship Systems Command (NAVSHIPS) awarded prime CPFF contract N00024-70-C-0252, with modifications to Newport News for long lead time materials for the DLG(N)'s

38, 39, and 40. Article 2 of this contract required Newport News to purchase shipsets of equipment for the DLG(N) 38 by exercise of options held by Newport News. On February 20, 1970, and April 30, 1970, Newport News exercised its options and purchased turbine generators and propulsion units for the DLG(N) 38. Contract modification No. 1, dated August 26, 1970, required that the purchase orders provide options for up to four additional shipsets of equipment.

In response to Newport News' requests for prices, GE offered option prices for propulsion units and turbine generators on September 9, 1970, and February 17, 1971, respectively. The prices quoted were as follows:

Propulsion units	
DLG(N) 39	$2,829,330
DLG(N) 40	$3,027,380
Turbine generators	
DLG(N) 39	$3,015,000
DLG(N) 40	$3,204,000

Newport News accepted these prices without any negotiation and without requiring GE to furnish supporting cost or pricing data. On March 22, 1971, Newport News requested the contracting officer's consent to exercise these options.

Article 21 of the prime CPFF contract incorporates by reference the April 1967 language of ASPR 7-203.8(a). This section requires that the request for consent include the proposed subcontract price; the contractor's cost or price analysis thereof; and, the subcontractor's current, complete, and accurate cost or pricing data and certification thereto. The request for consent included a copy of the proposed subcontracts (modifications to existing purchase orders), but did not include cost or pricing data. On April 6, 1971, the contracting officer granted his consent to procure the equipment without requiring Newport News to submit the required cost or pricing data.

NONCOMPLIANCE WITH ASPR REQUIREMENT FOR MAJOR SUBCONTRACTS

The ASPR provides that effective January 1, 1970, prime contractors who are required to submit cost and pricing data under

Public Law 87-653 must obtain and submit to the contracting officer, cost or pricing data in support of each subcontract estimate of $1 million or more included in the prime contractor's proposal. The prime contractor is also required to certify to the currency, completeness, and accuracy of the subcontractor's cost or pricing data.

CPFF contract N00024-70-C-0252 was converted to a FPI contract on December 21, 1971. During prime contract negotiations, which were completed on October 28, 1971, the contracting officer negotiated a total target cost and profit without reaching agreement on any specific cost element. He stated that only the costs for the DLG(N) 38 were analyzed, and that learning curves and extrapolation factors were used to determine the reasonableness of the price estimates for the DLG(N)'s 39 and 40.

Newport News had submitted its proposal on July 23, 1971. At that time, the subcontract for the turbine generators for the DLG(N) 39 had been awarded. Accordingly, the ASPR provision for supporting subcontract estimates of $1 million or more with subcontractor cost or pricing data was inoperable. However, cost or pricing data was required at the time of consent. See page 7. The other three subcontracts had not been awarded and the contracting officer again should have required Newport News to support these estimates.

CONTRACTING OFFICER DID NOT USE
DCAA SUBCONTRACT AUDIT RESULTS
TO REDUCE SUBCONTRACT PRICES

In June and July 1971, subsequent to the contracting officer's consent to Newport News to subcontract, but before the prime FPI contract N00024-70-C-0252 was negotiated, GE submitted contract pricing proposals and certificates of current cost or pricing data to Newport News. In September and October 1971, DCAA at Newport News requested DCAA at GE to perform preaward audits of GE's proposed costs for the DLG(N) 40 propulsion units and turbine generators.

The DCAA reports, which were received by the contracting officer after prime contract negotiations were completed, but before the subcontracts were awarded, disclosed that the proposed costs were higher than indicated by available cost or pricing data. The contracting officer, however, made no attempt to reduce the subcontract prices. In view of the cost reimbursable features of the prime contract, we believe that the contracting officer should have reduced the subcontract prices.

FAILURE TO ACT ON SUBCONTRACTOR'S OFFER TO REDUCE ITS PRICE

On December 30, 1971, DCAA (GE) submitted a defective pricing report on the turbine generators for the DLG(N) 39 to DCAA (Newport News) questioning $142,727. DCAA's audit findings were: (1) the hourly rates proposed for assembly and pipe labor and for test labor included a wage increase that was not scheduled to occur until after the delivery of the equipment; (2) the proposed hours were based on judgement, but actual experience was available from prior orders; and, (3) transportation costs were overstated.

DCAA (Newport News) forwarded the advisory report to the contracting officer and to the Supervisor of Shipbuilding, Conversion and Repair USN (SUPSHIP), at Newport News on January 6, 1972. SUPSHIP informed Newport News on February 1, 1972, of DCAA's audit results and requested to be advised of the action taken to effect an equitable adjustment. On September 18, 1972, Newport News advised SUPSHIP that GE had agreed to a price reduction of $69,516, because the hourly rates and the transportation costs were in error. GE did not agree to the total number of labor hours questioned.

Newport News and GE officials told us that SUPSHIP did not apprise them of any decision on GE's proposed settlement. The SUPSHIP's contract negotiator stated that the DCAA (GE) advisory audit report was included in the DCAA (Newport News) advisory audit report of post award on the prime contractor's cost proposal and was forwarded to the NAVSHIPS contracting officer who did not sustain any of DCAA's findings.

RECOMMENDATION

We recommend that you consider the above findings, along with any additional information available, to determine the extent to which the Government may be entitled to price adjustments and to identify procurement procedures that need to be improved.

\- - - - - - -

We would appreciate a written reply within 30 days expressing your views and comments on the matters discussed in this letter.

Sincerely yours,

JOSEPH EDER

Joseph Eder
Regional Manager