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IN REPLY REFER TO:

950143

15 OCT 1974

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Vice Admiral K.L. Lee
Commanding Officer
Naval Air Systems Command
Washington, D.C. 20360

BEST DOCUMENT AVAILABLE

Dear Admiral Lee:

As part of our continuing examination into contractor compliance with Public Law 87-653, we examined the reasonableness of the subcontract price for rotary antenna assembly systems (rotodomes) included in the price of fixed-price-incentive (FPI) contract N00019-72-C-0367. This contract was awarded Grumman Aerospace Corporation, Bethpage, New York, on January 21, 1972, by the Naval Air Systems Command (NAVAIR) for eight Model E-2C aircraft and related data. The rotodome subcontract was performed by Randtron Systems, a division of Randtron, Menlo Park, California.

Our examination was concerned with the reasonableness of the price negotiated in relation to cost or pricing data available to the contractor at the time the price was established. In this regard, we examined the Government's evaluation of the contractor's price proposal, and the cost or pricing data submitted in support of proposed subcontract cost.

We found that Grumman failed to disclose to the Navy negotiator complete pricing data regarding the establishment of the not-to-exceed (NTE) price for the eight lot rotodome buy. Had such pertinent information been furnished and evaluated, we believe there would have been a sound basis for negotiating a lower subcontract cost with a resulting decrease of about $646,853 in the prime contract's target price.

[Subcontract Price for Rotodomes in Contract N00019-72-C-0367]

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## PROCUREMENT HISTORY

The E-2C aircraft program was initiated in 1968 with Grumman as the prime contractor to convert two Model E-2A aircraft to E-2C configuration. During 1971, following this development effort, NAVAIR awarded Grumman the first production buy (N00019-71-C-0450) for eleven E-2C aircraft. The next year the contractor was awarded an advance procurement contract (N00019-72-C-0367) for the second production buy, and requested to submit a price proposal with supporting cost and pricing data.[1]

Grumman responded with an FPI price proposal dated April 24, 1972, for eight Model E-2C aircraft at a target price of $107,507,059. The proposal included a cost of $4,078,824 for eight rotodomes.

The Defense Contract Audit Agency (DCAA) performed a pre-award audit of the price proposal and submitted its report on June 16, 1972. The report did not address the reasonableness of the proposed rotodome cost pending receipt of an assist audit of the subcontractor's price proposal. By letter dated October 26, 1972, DCAA forwarded to NAVAIR a copy of the assist audit report.

In March 1973, Grumman furnished NAVAIR with an updated procurement position that reflected a negotiated subcontract price of $4,033,824 for the rotodome buy.

By letter dated April 5, 1973, DCAA provided NAVAIR with updated information regarding the second rotodome buy. Based on their review of Grumman's purchase order 10-42159 with Randtron, DCAA accepted a firm-fixed price of $4,033,504. This amount consisted of a negotiated purchase order (10-42159) price of $4,028,824 plus $4,680 for a contract modification.

In April 1973, the Navy negotiator established $4,033,504 as a reasonable prenegotiation position for the proposed rotodome cost. The basis for this position was an evaluation of the contractor furnished cost and pricing data, and DCAA audit reports. The established position remained unchanged in subsequent months.

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[1]Under the incentive clause of both FPI prime contracts, NAVAIR and Grumman would share on a 75/25 percent basis in any underrun or overrun in the final negotiated cost from target cost.

NAVAIR completed negotiations with the contractor on September 5, 1973. Both parties agreed to a target cost and price of $79.1 and $87.7 million respectively, and a ceiling price of $98.2 million. The contractor executed a Certificate of Current Cost or Pricing Data on September 17, 1973, and certified the cost data through September 5, 1973.

According to the Navy negotiator, Grumman did not furnish NAVAIR, during contract negotiations, with any information indicating that a lower prenegotiation price could have been established with the subcontractor. Therefore, the Government did not consider such information before accepting the proposed rotodome cost as a basis for establishing a target cost under contract N00019-72-C-0367. As explained below, this information was important and should have been furnished for consideration to the Government because the prenegotiation price had determined the NTE and, in turn, the negotiated rotodome subcontract price.

## DEFECTIVE PRICING DUE TO CHANGES IN PRENEGOTIATION SUBCONTRACT PRICES

The proposed and accepted subcontract cost for the eight rotodomes was higher than warranted because Grumman did not take advantage of the lowest offered prenegotiation price, resulting in a $4.033 rather than $3.533 million subcontract price. The subcontract was $500,000 higher because the contractor requested Randtron to increase the initial prenegotiation price by shifting certain start-up cost from the eleven to the eight lot rotodome buy. We believe the request was made by Grumman to avoid a cost overrun under the eleven lot buy resulting from termination cost caused by a change in subcontractor.

### Change in subcontractors for technical and price considerations



In September 1968, Grumman awarded Dalmo Victor Company (DV), a division of Textron, Belmont, California, letter purchase order 6-24412 to develop three preproduction rotodomes. In January 1971, DV was awarded change order 28 for eleven production rotodomes, and was requested to start contract negotiations to definitize the price.

In October 1971, after stalled contract negotiations, Grumman started to seek an alternative rotodome supplier for the eleven and the eight lot follow-on rotodome buy. After considering various contractors including DV, Grumman selected Randtron as the new subcontractor and, on December 23, 1971, terminated DV's production of the production rotodome buy for the buyer's convenience. According to Grumman, DV was terminated for technical and cost considerations.

Contractor request to revise prenegotiation price

Prior to DV's termination, Grumman requested from Randtron price quotations for the first and second rotodome buys. Between December 2 and 9, 1971, the subcontractor responded with three pertinent price quotations.

| | Prenegotiation price quotes | | |
|---|---|---|---|
| Sequence | First buy (11 lot) | Second buy (8 lot) | Combined buy |
| First quote | $5,355,680 | $3,298,000 | $8,653,680 |
| Second quote | 5,618,063 | 3,528,824 | 9,146,887 |
| Third quote | 5,118,063 | 4,028,824 | 9,146,887 |

According to Randtron management (1) the price increases for both buys between the first and second quote resulted from the use of updated material cost estimates, and (2) the $500,000 price increase for the second buy between the second and third quote resulted from Grumman's request to shift estimated start-up cost from the first to the second rotodome buy. We were further told Grumman justified this unusual request by stating that without the price shift they would experience a cost overrun under the first buy due to the change in subcontractors and, consequently, could better afford to pay for the $500,000 under the second buy. (Reasons for Grumman's request are discussed on page 6.)

On December 22, 1972, Grumman signed with Randtron an agreement outlining the specific terms of the rotodome procurement. Following this agreement, the subcontractor was awarded letter purchase order 7-85525 for eleven rotodomes. Both the agreement and purchase order confirmed the revised prenegotiation price by providing the contractor with an option to purchase eight rotodomes at an NTE price totalling $4,028,824.

In his April 1972 price proposal, the contractor included the above NTE price plus $50,000 for data as the basis for the $4,078,824 in proposed rotodome subcontract cost. The proposal, however, did not disclose to the Navy that the contractor had rejected the initially offered lower prenegotiation price and, therefore, had failed to negotiate the lowest NTE price for the eight lot rotodome buy.

NTE price determines subcontract cost

In response to the contractor's request, Randtron submitted a price proposal dated May 10, 1972. The proposed price for the second rotodome buy totalled $4,279,677.

DCAA reviewed the subcontractor's price proposal, and in its assist audit report dated July 14, 1972, questioned for various reasons $1,041,179 in proposed cost. Based on a discussion with a DCAA official and a review of their audit report and related workpapers, we found no indications that Randtron or Grumman disclosed to them any information regarding the revised eight lot prenegotiation price and its impact on the NTE price.

On October 3, 1972, Grumman awarded Randtron letter purchase order 10-42159 for eight rotodomes and, on October 12-13, 1972, both parties negotiated a $4,028,824 price. According to Grumman's price justification, the contractor negotiated the second together with the first buy because the subcontractor in his price proposal had spread non-recurring cost over both buys. While the basis for the negotiated price included the DCAA assist audit report and Grumman's own evaluation of the subcontractor's price proposal, the overriding consideration in the negotiation was the constraint imposed by the NTE price. It determined the subcontract price and, in turn, the cost included as a basis for negotiating the target cost under contract N00019-72-C-0367, as shown below.

| Description | Eight lot rotodome prices |
|---|---|
| NTE price | $4,028,824 |
| Subcontractor's proposed price | 4,279,677 |
| Negotiated purchase order price | 4,028,824 |
| Rotodome purchase order price included as basis for negotiated target cost | 4,033,504[1] |

[1]The amount consisted of the initially negotiated $4,028,824 rotodome price plus a $4,680 purchase order modification for increased rotary coupler unit cost.

Impact on cost had Grumman accepted the lower prenegotiation price

Our estimate of the overpricing is based on Randtron's $3,528,824 initial prenegotiation price which was available for the second rotodome buy. For comparison purposes, the price was increased by $4,680 to allow for the contract modification. The following schedule summarizes our estimate of the impact on negotiated target cost under contract N00019-72-C-0367 had the contractor accepted the lower prenegotiation price.

| Cost elements | Base | Negotiated rate[1] | Negotiated amount |
|---|---|---|---|
| Rotodome subcontract | $4,033,504 | 100% | $4,033,504[2] |
| GAC material overhead | 4,033,504 | 5% | 201,675 |
| GAC corporate G&A | 4,235,179 | 11% | 465,870 |
| Subtotal | | | $4,701,049 |

| Cost elements | Revised base | Negotiated rate[1] | Revised amount |
|---|---|---|---|
| Rotodome subcontract | $3,533,504 | 100% | $3,533,504 |
| GAC material overhead | 3,533,504 | 5% | 176,675 |
| GAC corporate G&A | 3,710,179 | 11% | 408,120 |
| Subtotal | | | $4,118,299 |
| Total target cost reduction using revised rotodome subcontract cost | | | $ 582,750 |

[1]Based on the estimated weighted average, GAC material overhead and corporate G&A overhead rate used by the Navy in computing the cost for the Amecon subcontract. (See Post Negotiation Business Clearance 1157.3, dated September 10, 1973.)

[2]Based on the Supplemental Pre-Negotiation Business Clearance 11575.2, dated June 28, 1973.

Additionally, based on the 11 percent profit rate used in contract negotiations, the changes resulting from use of the lower rotodome subcontract cost would affect a $64,103 reduction in profit, amounting to a total price reduction of $646,853.

Reasons for the request to change rotodome lot prices

In our opinion, Grumman was concerned that the $5,618,063 eleven lot price plus the to be determined net DV termination cost would exceed the $6,411,000 subcontract cost for rotodomes included in the target cost under prime contract N00019-71-C-0450. Such overrun condition was obviously to Grumman's disadvantage because, since the prime contract had been negotiated in September 1971, the contractor was required to share with the Government in the effects of the cost overrun under the 75/25 percent incentive cost sharing provision of the prime contract. Based on currently available actual cost data, we estimate the overrun as follows:

| Contract N00019-71-C-0450 | Amount |
|---|---|
| Estimated rotodome cost included in negotiated target cost[1] | $6,411,000 |
| Estimated actual rotodome cost if the contractor had accepted the higher eleven lot rotodome price quote (For details see Appendix A) | 6,849,089 |
| Estimated cost overrun | $ 438,089 |
| Government share - 75 percent | $ 328,567 |
| Grumman share - 25 percent | $ 109,522 |

[1]Based on the supplemental to Clearance AIR 1187.4, dated September 3, 1971.

As can be seen above, the estimated cost overrun was more than offset by the subcontractor's $500,000 reduction in the eleven lot price. Since prime contract N00019-72-C-0367 was not negotiated until September 1973, the contractor was able to pass on to the Government the $500,000 increase in the eight lot prenegotiation price.

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We discussed the above findings with Grumman officials and they did not dispute that Randtron was requested to increase the eight lot prenegotiation price quote by shifting start-up cost from the eleven to the eight lot rotodome buy and, since these prices were negotiated, that the cost shift resulted in a higher eight lot rotodome price. However, the officials disagreed that this was a case of defective pricing because the contractor justified to the Navy the reasonableness of the second lot firm-fixed rotodome price and, in that justification, referred to the spread of start-up cost between the two rotodome buys. Accordingly, the officials contended that the Navy should have requested clarification if indeed the matter was of concern to them. Finally, these officials believed that overriding the price shift issue was the change in subcontractor from Dalmo Victor to Randtron. They contend the change saved the Government millions of dollars in lower subcontract cost at considerable initial risk to Grumman. Consequently, management at all levels was primarily concerned with the risk factors and possible reductions of risks. In this regard, they stated the reduction of the first lot price at the expense of the higher second lot rotodome price was a matter of shifting some business risk from Grumman to Randtron.

Although we commend Grumman for the development of an alternate rotodome supplier, and recognize the possible long-term benefits to the Government, we believe these factors are not relevant to the central issue of providing the Government with complete cost and pricing data. With regard to contractors' data submissions supporting their contract proposals, ASPR 3-807.3(i) states:

> "The requirement for submission of cost or pricing data is met when all accurate cost or pricing data reasonably available (see 3-807.5(a)(1)) to the contractor at the time of agreement on price is submitted, either actually or by specific identification, in writing to the contracting officer or his representative. The distinction between the 'submission' of cost or pricing data and the 'making available' of records should be clearly understood. The mere availability of books, records and other documents for verification purposes does not constitute submission of cost or pricing data."

We also disagree with Grumman that their reference to spreading of non-recurring cost over the two rotodome buys in the justification of the firm-fixed price should have triggered a Navy inquiry regarding the reasonableness of the NTE price. In our view, the processes involved which led to the NTE and negotiated subcontract prices were sufficiently distinct and different to require the contractor to separately identify in its proposal all pertinent information, including the fact that it had requested Randtron to increase its prenegotiation price quotes. Furthermore, the NTE price and the events leading to its establishment appears to be less a matter of shifting start-up cost than of artificially increasing the eight lot rotodome price in order to avoid a cost overrun and lower profit on another Navy contract.

Accordingly, we believe the contracting officer should consider the above facts, along with other available information, to determine the extent to which the Government may be legally entitled to a price adjustment. As part of this evaluation, we believe that the contracting officer should determine if the contractor's action was an attempt to avoid sharing with the Government in cost overruns as required under the incentive provisions of the prime contracts.

We would appreciate your written comments on this letter within 60 days. For your information we are also sending copies of this report to the Defense Contract Audit Agency, New York; and the Commander, Defense Contract Administration Services Region, San Francisco.

Sincerely,

A. M. CLAVELLI

A.M. Clavelli
Regional Manager

cc: Naval Plant Representative,
  Grumman Aerospace Corp.
 Commander, DCASR-SF
 Manager, DCAA--New York
 Mr. Hammond, PSAD/GP

APPENDIX A

SCHEDULE SHOWING ESTIMATED
ELEVEN LOT ROTODOME COST IF
GRUMMAN HAD ACCEPTED THE HIGHER
RENEGOTIATION PRICE FROM RANDTRON

| Cost element | Amount |
| --- | --- |
| Prenegotiation price | $5,618,063 |
| Contract modification to PO 7-85525 | 9,987 |
| DV net termination cost | 1,197,039 |
| Lease cost for GAC furnished test range | 24,000 |
| Grumman cost to transfer inventory from DV to Randtron | Not identifiable |
| Total | $6,849,089 |