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UNITED STATES GENERAL ACCOUNTING OFFICE  
REGIONAL OFFICE  
ROOM 717, GATEWAY II BUILDING  
4TH AND STATE  
KANSAS CITY, KANSAS 66101

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December 22, 1975

Lieutenant General James T. Stewart  
Commander  
Aeronautical Systems Division (AFSC)  
Wright-Patterson Air Force Base, Ohio 45433

Dear General Stewart:

We have performed a survey of the pricing of F-15 aircraft spare parts under fixed price incentive contract F33657-73-C-0267 awarded to McDonnell Aircraft Company in November 1972. Acquisitions totaled \$31,549,067 for fiscal year 1973 and \$84,752,951 for fiscal year 1974. Fiscal year 1975 acquisitions had not been negotiated at the completion of our survey in December 1975.

Our examination of selected transactions and our observations of the overall procurement process indicate that a significant portion of these transactions was negotiated on the basis of overstated subcontractor price quotations and without the use of supporting detail cost breakdowns. While negotiations between McDonnell and the Air Force were accomplished by utilizing a decrement factor to decrease subcontractor price quotations, our examination of negotiated results between the contractor and F-15 spares subcontractors showed that the decrement factors used in Air Force/McDonnell negotiations were not sufficient to compensate for the reductions actually being experienced.

We believe that this process has resulted in less than a realistic basis for price negotiation and has resulted in increased costs to the Government. We have made no attempt to measure the full extent of additional costs incurred but are providing you these survey results for consideration and appropriate management action.

ACQUISITION PROCESS FOR FISCAL YEARS 1973 AND 1974 SPARES

McDonnell cost proposals for spares were based on subcontractor quotations, "L" type purchase order prices (purchase orders having established ceiling prices which are subject to downward negotiations),

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or production option prices. Air Force/McDonnell negotiations were based on subcontractor price quotations or "L" purchase order prices most of the time. These negotiations were accomplished using decrement factors to reduce firm subcontractor price quotations to reflect expected average negotiated results between McDonnell and the subcontractors.

The fiscal year 1973 Spares Pricing Agreement negotiated with McDonnell by the F-15 System Program Office provided for a decrement factor of 8 percent. The fiscal year 1974 Spares Pricing Agreement was negotiated with McDonnell by the Air Force Plant Representative Office and contained a decrement rate of 18.2 percent to be applied to proposals based on subcontractor price quotations or prices on "L" type purchase orders. McDonnell proposed the 18.2 percent decrement factor, however, the Defense Contract Audit Agency found that subcontractor price quotations on "L" purchase orders were being reduced an average of 29 percent in arriving at the negotiated price. The Air Force representative involved in the negotiations was of the opinion that these calculations included the effect of costs which were disallowed. He felt such reductions would not occur in future negotiations and the 29 percent was not a realistic value for negotiation purposes; however, he had no calculations to support his opinion.

Our examination of all "L" type purchase orders issued under the spares contract on which negotiations were completed as of February 21, 1975, showed the average reduction to be 26.6 percent.

#### REVIEW OF TRANSACTIONS

We traced a number of transactions through the process described above and found examples of Air Force/McDonnell negotiated prices based on subcontractor price quotations being significantly higher than the McDonnell/subcontractor price subsequently negotiated.

#### Example

PO #4B0199 issued to Sperry Flight Systems/Sperry Rand Corporation had an initial (maximum) price of \$128,625. A firm fixed price of \$47,606 was negotiated, resulting in a 63 percent reduction. Our analysis of four items on this purchase order disclosed that the subcontractor proposed price was \$65,491. The Air Force and McDonnell negotiated a cost of \$60,252 using an 8 percent decrement factor. Subsequent McDonnell/subcontractor negotiations resulted in a price of \$21,050. Supporting cost data for the Sperry proposal was provided in April 1974. The Defense Contract Audit Agency questioned 60 percent of the proposal costs in an audit report about a month before the Air Force/McDonnell negotiations were concluded based on the original pricing for the four items selected. We found no evidence to indicate that any consideration was given to the audit data.

### Example

PO #4E0157 issued to General Electric Aircraft Equipment Division was initially priced at \$136,137. A firm fixed price of \$76,215 was negotiated resulting in a 44 percent reduction. Our analysis of four items on this order revealed that the subcontractor proposed price was \$44,850. The Air Force and McDonnell negotiated a cost of \$41,262 using an 8 percent decrement factor. Subsequent McDonnell/subcontractor negotiations resulted in a price of \$24,800 or a reduction of 55 percent. We found no indications that detail cost data was provided for these items before Air Force/McDonnell negotiations were concluded.

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Personnel of the Air Force Plant Representative Office stated that the approach being followed in spares pricing was the most cost-effective for forward pricing of small lot orders. They pointed out that use of the fixed price incentive contract minimizes the impact of any overpricing.

We agree this type of contract does lessen adverse cost impact as the Government ultimately shares in the net effect of overpricing; however, price sharing arrangements provide for the Government to recover only 80 percent of such overpricing. It does not preclude overpricing from occurring and our examination indicates that the decrement factors used were not sufficient to compensate for the adverse impact.

We were advised by a representative of the Air Force Plant Representative Office that fiscal year 1975 acquisitions have been consolidated and will be negotiated in one package. However, he stated that a decrement factor to adjust subcontractor price quotations will still be used in arriving at a final negotiated price.

### OBSERVATIONS AND OPINIONS

Based on our survey of this procurement process, we feel that additional costs to the Government are being incurred because:

- initial (maximum) price quotations are being accepted by the Air Force for pricing basis with no supporting detail cost information.
- quoted prices are being significantly reduced in many cases in subsequent negotiations between McDonnell and the subcontractors.
- decrement factors utilized are less than the actual reductions being experienced.

We believe viable alternatives are available for consideration. These include more efficient definitization of decrement factors and greater use of cost and audit information.

We recommend that the Air Force reevaluate its concept of pricing aircraft spares with the objective of identifying cost-effective changes that would provide a basis for negotiating prices more favorable to the Government. Since negotiations for fiscal year 1975 acquisitions should take place in early 1976, it is imperative that action be initiated promptly.

We would appreciate your advising us within 45 days of any action taken or contemplated in response to issues raised in this letter.

Sincerely yours,

K. L. Weary  
Regional Manager

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