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UNITED STATES GENERAL ACCOUNTING OFFICE
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AUG 25 1976

Lt. General W. W. Vaughan
Director, Defense Supply Agency
Cameron Station
Alexandria, Virginia 22314

Dear General Vaughan

The General Accounting Office has recently completed several reviews of the Defense Fuel Supply Center's (DFSC) practices in awarding and administering petroleum fuel contracts and have issued reports to the Congress containing certain matters of interest to them. In addition to the matters reported to the Congress, we found other matters which we believe needed corrective action. We discussed these matters with DFSC officials at the completion of our review, and they concurred in our conclusions and recommendations. We subsequently met with DFSC officials in February 1976, and found that corrective action has been taken.

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The matters we discussed with DFSC officials and identified in this report are that DFSC (1) paid an additional \$560,000 by allowing contractors to base economic price adjustments on a product other than the product being purchased and (2) did not seek price reductions from contractors in return for granting product specification waivers.

BACKGROUND

The DFSC is responsible for procuring petroleum products for the Department of Defense (DOD) and other Federal agencies. It buys about one-third of a billion barrels annually and until 1973 bought most domestic products under formally advertised contracts. However, by late 1973, traditional suppliers were not interested in furnishing all the Government's requirements either by competitive bidding or through negotiations and DFSC had to make arrangements with the Department of the Interior to obtain the needed products under mandatory allocations pursuant to the Defense Production Act of 1950 (DPA), as amended. The Department of the Interior then issued

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directives pursuant to the DPA to suppliers requiring them to deliver various quantities of specified petroleum products in accordance with schedules and contracts developed between the suppliers and DFSC. After the directives were issued, DFSC negotiated 21 contracts for \$175 million and thus obtained contractual coverage for most of the Government's needs through January 1974. The matters discussed in this letter deal primarily with those contracts awarded by DFSC under the DPA.

Details concerning the results of our review follow.

ECONOMIC PRICE
ADJUSTMENT CLAUSES

Economic adjustment of a contract price is appropriate when serious doubt exists as to the stability of market conditions during the contract period. It is intended to protect the interest of both the Government and contractor. It provides an upward contract price adjustment if the price of the product being purchased increases, and a downward adjustment if the price of the product being purchased decreases.

We reviewed 26 contract products for which DFSC negotiated economic price adjustment provisions. We found that 13 were based on prices of products where the connection to the contractor's cost of operation or the prices charged to others was not apparent or clearly established.

In two of the cases where DFSC allowed the contractor to base the economic price adjustment on a product other than the product purchased, we found that the referenced product's price increased more than the product being purchased. We estimate that this resulted in about a \$560,000 increased cost to the Government.

We brought this matter to the attention of DFSC officials and we were told that at the time of award of the contracts reviewed, it was necessary to expedite the negotiation of the petroleum contracts and that some of the price escalation references selected may not have directly affected the price of the products being purchased. The Commander of DFSC told us that currently, DFSC policy is to clearly establish that all references used for economic price adjustments have a direct effect on the price of the product being purchased. We are of the opinion that DFSC's continued application of this new policy will preclude the unnecessary upward economic adjustment of fuels contracts.

POLICY ON SEEKING CONSIDERATION FOR
GRANTING PRODUCT SPECIFICATION WAIVERS

Federal procurement law provides that contract amendments which benefit a contractor should include corresponding benefits to the Government and that the adequacy of those benefits should be examined in light of the benefits granted to the contractor. In addition, DFSC's manual for managing procurement of petroleum products requires that the contracting officer seek an equitable adjustment of the contract price or other consideration when contract waivers are granted to contractors

We found that DFSC granted a number of waivers of product specifications in response to contractors' requests and issued amendments under the contracts to provide for such waivers without attempting to obtain from the contractors a corresponding equitable adjustment of contract price or other consideration.

As part of our review of DFSC's practices in granting product specification waivers we examined 26 waivers granted by DFSC during the period March 1973 to February 1974 in response to contractors' requests under 15 different contracts.

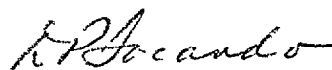
Of the 26 waivers, a price reduction was included in the contract modification in 4 instances but no price reduction was involved in the other 22 instances. About 19 million gallons of petroleum products were involved in the four specification waivers on which DFSC obtained price reductions. The total price reduction obtained was over \$33,000. We believe that if similar price reductions were negotiated on the approximately 91 million gallons involved in the 22 other instances where waivers were granted without monetary consideration, substantial additional savings would have been realized. We recommended that DFSC obtain adequate consideration when a contractor is granted a waiver to contract requirements.

In a February 1976 meeting with DFSC officials, they agreed that DFSC should have made further efforts to obtain monetary consideration for some of these waivers. They advised us that they have issued a new policy dated May 9, 1975, which strengthens the guidelines for granting waivers. Also, the Director of DFSC advised us that he now personally reviews each waiver request to determine whether monetary consideration should be obtained.

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We believe the corrective action taken by DFSC on the matters discussed in this letter is sufficient to prevent recurrence of the conditions described above. We would like to express our appreciation for the cooperation we received and for the prompt action taken to correct the above problems.

Sincerely,



D. P. Sorando
Regional Manager