DOCUMENT RESUME

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[Reasonableness of Noncompetitive Contract Prices Proposed and Negotiated for 1976 Deliveries of 111 TF-41 Engines]. PSAD-77-77; B-133341. January 31, 1977. 3 pp.

Report to Secretary, Department of Defense; by Richard W. Gutmann, Director, Procurement and Systems Acquisition Div.

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Federal Procurement of Goods and Services: Reasonableness of Prices Under Negotiated Contracts and Subcontracts (1904).
Contact: Procurement and Systems Acquisition Div.
Budget Function: National Defense: Department of Defense - Procurement & Contracts (058).
Organization Concerned: Department of the Air Force: Aeronautical Systems Div., Wright-Patterson AFB, OH; General Motors Corp.: Detroit Diesel Allison Div., Indianapolis, IN; Rolls-Royce, Ltd.
Congressional Relevance: House Committee on Armed Services; Senate Committee on Armed Services.
Authority: P.L. 87-653.

The primary objective of a review of noncompetitive contract prices was to determine whether the negotiated price was reasonable and based on cost and pricing data available to the contractor when the price was established. The Government's evaluation of the contractor's proposal, the cost or pricing data submitted in support of proposed costs, the negotiation process and, on a selected basis, the cost incurred were examined. Findings/Conclusions: No apparent defective pricing on the subject contracts was found; however, GAO noted that Air Force negotiations apparently failed to consider established overhead and profit factors when negotiating a contract price adjustment clause for foreign exchange rate fluctuation. As a result, the contractor may receive an unintended economic benefit due to the fluctuation in the exchange rate between the U.S. dollar and the British pound sterling. The Air Force and the contractor recognized that currency exchange rates fluctuate and that the amount of overhead costs and profit assigned to the contracts was based on material costs. The net result was an increase of 24 percent on the material costs. GAO thinks that the negotiated 15 percent overhead and profit factor does not satisfy the intent of the price adjustment clause in the contracts, and the apparent failure to recognize the intent of the price adjustment clause could have an impact on negotiations for future commodities purchased from foreign companies. Recommendations: The Air Force should attempt to get full recovery of the 24 percent increase during the final currency fluctuation pricing settlement. The Air Force should also give particular attention to calendar year 1977 TF-41 engine pricing negotiations and future purchases of other foreign equipment to preclude contractors from gaining windfalls from foreign

exchange rate fluctuations. (Author/SS)

UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

PROCUREMENT AND SYSTEMS ACQUISITION DIVISION

JAN 31 1977

B-133341

The Honorable
The Secretary of Defense

Dear Mr. Secretary:

As part of a review of the reasonableness of noncompetitive contract prices negotiated under provisions of Public Law 87-653, we examined the price proposed and negotiated for 1976 deliveries of 1[illegible] TF-41 engines. The engines were purchased by Aeronautical Systems Division (ASD), Air Force Systems Command, from Detroit Diesel Allison Division of General Motors (Allison), Indianapolis, Indiana, under fixed price-redeterminable contracts F33657-73-C0005, F33657-75-C0154, F33657-75-C0155, and F33657-75-C0156. The 1976 engine deliveries were priced on December 19, 1975.

Our primary objective was to determine whether the negotiated price was reasonable and based on cost and pricing data available to the contractor when the price was established. We examined the Government's evaluation of the contractor's proposal, the cost or pricing data submitted in support of proposed costs, the negotiation process and on a selective basis, the cost incurred. Our review disclosed no apparent defective pricing on the subject contracts, however, we noted that ASD negotiators apparently failed to consider established overhead and profit factors when negotiating a contract price adjustment clause for foreign exchange rate fluctuation. As a result, Allison may receive an unintended economic benefit expected to be about $265,800 due to the fluctuation in the exchange rate between the U.S. dollar and the British pound sterling.

The TF-41 engine was developed jointly by Allison and Rolls-Royce Limited in Derby, England. Allison purchases a major portion of the engine from Rolls-Royce and negotiates the price for these parts in British pounds sterling. Allison, in turn, prices such parts to ASD in United States dollars. During the negotiations completed in December 1975, Allison and ASD agreed to a $2.10 per British pound exchange rate to price the parts. The Rolls-Royce parts represent $24 million of the $68.6 million total price.

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Allison and ASD recognized that currency exchange rates fluctuate and agreed to a contract price adjustment following delivery of the engines if the exchange rate varied from the established $2.10 rate. The intent of the agreement was that the contractor would not realize economic benefit or incur economic losses by reason of currency fluctuations. The parties further recognized that the amount of overhead costs and profit assigned to the contracts was based on material costs and that a percentage factor must be added to any exchange rate variance to account for these cost elements. The factor agreed upon was 15 percent.

The records are clear as to the specific overhead and profit rates applied to material costs during the negotiations. These factors increase material cost by over 24 percent. A review of the negotiation records disclosed no basis or formula for establishing the 15 percent overhead and profit factor and the ASD negotiator informed us no clear basis or formula was used. Allison officials, while declining to comment on our conclusions, agreed that our computations were accurate and that historically overhead and profit have been determined as a percentage of material cost.

Allison officials expect the actual average exchange rate to be about $1.85 per British pound. Assuming this rate, the material cost variance will be about $2,866,000 and related overhead and profit of over 24 percent would be about $695,700. The negotiated 15 percent factor applied to the material cost variance amounts to only about $429,900 and Allison may receive the windfall difference of $265,800.

We believe the negotiated 15 percent overhead and profit factor does not satisfy the intent of the price adjustment clause in the contracts because Allison could thus realize an unintended economic benefit from the fluctuating currency exchange rate. We further believe the apparent failure to recognize the intent of the price adjustment clause could impact on negotiations for future TF-41 engines or other commodities purchased from foreign companies.

In view of the intent of the price adjustment clause, we recommend that you instruct the Air Force to pursue full recovery of the 24 percent overhead and profit increase during the final currency fluctuation pricing settlement. We also recommend that the Air Force give particular attention to calendar year 1977 TF-41 engine pricing negotiations and future purchases of other foreign equipment to preclude contractors from gaining windfalls from foreign exchange rate fluctuations.

We would appreciate being advised of any actions you intend to take on this matter. As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions he has taken on our recommendations to the House and Senate Committees on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's final request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Director, Office of Management and Budget; the Chairmen of the Senate and House Committees on Appropriations, Armed Services, and Government Operations; and the Secretary of the Air Force.

Sincerely yours,

R. W. Gutmann
Director