B-202369

MAY 12, 1981

The Honorable Samuel S. Stratton
Chairman, Subcommittee on Procurement
and Military Nuclear Systems
Committee on Armed Services
House of Representatives

Dear Mr. Chairman:

Subject: Fort Monmouth Procurement Activities: Inappropriate Contract Actions May Increase Government Costs (PLRD-81-14)

On May 8, 1980, in your capacity as Chairman, Subcommittee on Investigations, House Committee on Armed Services, you asked us to review

--contract DAAK80-79-C-0805 awarded by the U.S. Army Communications Research and Development Command (CORADCOM), Fort Monmouth, New Jersey, for the Joint Interface Test System, and

--the entire scope of the U.S. Army Communications and Electronics Material Readiness Command (CERCOM) acquisition activity at Fort Monmouth.

On September 5, 1980, we sent you our report concerning contract DAAK80-79-C-0805. In discussions with your Office on the second part of your request, we agreed to restrict our review to:

--Assessing whether CERCOM took followup actions designed to correct deficiencies noted in an Army report and assessing the adequacy of these actions.

--Reviewing the award by all three Fort Monmouth procurement activities--CERCOM, CORADCOM, and the U.S. Army Electronics Research and Development Command (ERADCOM)--of cost-type contracts based on design, technical, or other-than-price competition to determine whether Government negotiators took appropriate actions to prevent or control potential additional costs.

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In fiscal year 1980, the three Fort Monmouth procurement activities spent about $1.3 billion. CERCOM is responsible for follow-on acquisition and material readiness for all communication and electronic products which have been fielded and or which meet the criteria for transfer from ERADCOM and CORADCOM. ERADCOM is responsible for electronics research and for developing and acquiring electronics material other than communication systems. CORADCOM is responsible for researching, developing, and acquiring communications, tactical data, and command control systems.

We examined (1) the procurement management review (PMR) report on CERCOM, issued by the U.S. Army Material Development and Readiness Command (DARCOM) in December 1978, (2) CERCOM's asserted corrective actions, and (3) internal reviews to determine whether CERCOM's actions had corrected the reported deficiencies.

We also reviewed contracts and modifications which were based on design, technical, or other-than-price competition awarded by CORADCOM and ERADCOM to determine whether there was cost growth during fiscal year 1980. There were 27 of these actions valued at $20 million. We reviewed 13 actions valued at about $17 million. Ten of the 13 were selected because they were the largest actions relating to equipment purchases, while the remaining 3 were randomly selected. We wanted to determine whether Government negotiators took appropriate actions to reduce potential additional costs due to cost growth.

We examined pertinent records and interviewed Government officials but did not interview contractor personnel or review contractors' records. We did no work at CERCOM because it informed us that it had no procurement actions based on design, technical, or other-than-price competition.

As your Office requested, we did not obtain agency comments on this report.

We found that:

--CERCOM issued new instructions and instituted organizational changes designed to correct the deficiencies noted in the Army's PMR report. However, CERCOM has performed insufficient evaluations to determine whether the new instructions and/or organizational changes have corrected all of the reported deficiencies.

--CORADCOM and ERADCOM procurement activities did not take appropriate action in three cases to protect the Government from incurring liability for costs that the contractor either offered to absorb or should have absorbed.

CERCOM DOES NOT KNOW WHETHER DEFICIENCIES HAVE BEEN CORRECTED

CERCOM has not adequately evaluated actions taken in response to the Army's PMR report. CERCOM's Commanding Officer's instructions limited the Inspector General's review to determining whether promised corrective actions were implemented, not whether they were effective. In addition, the compliance review branch has not evaluated the effectiveness of the implementation of all procurement information letters. Consequently, CERCOM does not know whether its changes and/or instructions have corrected all of the reported deficiencies.

During August and September 1978, DARCOM representatives reviewed purchasing and contract administrative operations at CERCOM. The Army's PMR report contained 22 recommendations to CERCOM and 4 recommendations to other commands.

In response to the PMR report, CERCOM said in February 1979 that it had taken or was to take corrective actions on the 22 recommendations addressed to it as well as 2 recommendations addressed to other commands. The corrective actions involved changing the organizational structure, revising procedures, writing guidance, and changing procurement personnel career management programs. Eleven of the 22 recommendations resulted in the issuance of procurement information letters (basic instructions for use in the procurement process).

Under its policy on PMR followup procedures, CERCOM's Inspector General performed a one-time review in January 1980. Normally, the Inspector General's review would have evaluated both the implementation and effectiveness of CERCOM's corrective actions. However, in response to the Commanding General's instructions, the Inspector General evaluated only the implementation of the corrective actions. The compliance review branch was to evaluate the effectiveness of these actions. The Inspector General found that, overall, CERCOM had carried out the corrective actions and that the deficiencies identified were insignificant and did not detract from mission effectiveness.

The Inspector General's review included an examination of procurement instructions and discussions with procurement personnel. It did not include a determination of whether CERCOM personnel were complying with the new instructions. Some contract files were reviewed to determine whether CERCOM was preparing independent Government cost estimates. After reviewing three negotiated procurements, the Inspector General concluded that CERCOM personnel were not complying with the new instructions. The Inspector General, however, found CERCOM's compliance adequate because his assessment referred only to the specific action CERCOM said it would take, that is, issue an instruction.

One of the PMR recommendations was that CERCOM establish a compliance review capability. In February 1979 CERCOM established a compliance review branch which was responsible for conducting compliance reviews of policy and procedure implementation. As of February 1980, the branch had reviewed the implementation of only 5 of 11 procurement information letters issued by CERCOM and concluded that CERCOM personnel had complied with the 5 letters.

Because CERCOM's compliance review branch has not reviewed the implementation of the remaining six letters, CERCOM does not, in our opinion, know whether the letters and their implementation have corrected the reported deficiencies.

Recommendation

We recommend that the Secretary of the Army direct DARCOM to have its subordinate command, CERCOM, promptly review all remaining corrective actions to ensure that CERCOM's implementation has, in fact, corrected the problems.

PROCUREMENT ACTIVITIES DID NOT ALWAYS TAKE APPROPRIATE ACTION TO PROTECT THE GOVERNMENT FROM POTENTIAL ADDITIONAL COSTS

We found that, in several cases, procurement activities did not take appropriate action to protect the Government from incurring costs that the contractor either offered to absorb or should have absorbed. At CORADCOM, we found two cases where the Government could incur an undetermined amount of additional costs because it did not include contractual clauses requiring the contractor to absorb certain costs under its offer. At ERADCOM, we found one case where the Government unnecessarily incurred an additional $1.4 million of overhead cost growth.

In cost-type awards, the Government is required to pay costs that are reasonable, allowable, and allocable to the contract. Consequently, if contractors reduce their proposed costs to make their proposals more competitive, they know that they will be reimbursed for all necessary, allowable, and allocable costs unless an agreement to the contrary is established or unless the Government orders them to cease work. The Government's interests were not protected in these three cases because, in our opinion, contracting officials failed to recognize the need for special handling of these costs.

In 3 of the 13 actions we reviewed (8 awarded by CORADCOM and 5 by ERADCOM), events occurred that increased, or could have increased, the cost borne by the Government in the event of cost overruns. At CORADCOM, we found two additional actions that also could have increased cost to the Government. However, they were properly handled by contracting officials, and the potential for increased costs was avoided. Details of the five cases follow.

1. On December 14, 1979, one of three offerors submitted to CORADCOM its proposal, totaling $8.8 million, for the Joint Tactical Microwave Landing System. On February 25, 1980, the offeror submitted a revised proposal totaling $6.5 million, or a reduction of $2.3 million (costs $1.7 million and fee $0.6 million). The offeror stated that it had made significant investments in a civilian microwave landing system and that the defense program would benefit technically and economically from the offeror's continued involvement in civilian activities. In the revised proposal, the offeror agreed to do the contracted work at cost, no fee. The offeror further proposed to share the cost with the Government of any overrun which might develop.

On May 30, 1980, CORADCOM awarded to the offeror a cost-plus-fixed-fee contract with zero fee at an estimated cost of $5,936,654. The basis for the award was that the offeror had the best technical, management, and cost proposal. Although the contract provided for zero fee, the contractor's offer to share in any cost overrun was not incorporated into the contract.

The contracting officer told us that a cost-sharing arrangement was not included in the contract because there was inadequate information at negotiations to develop an agreement. In our opinion, the contracting officer did not offer a satisfactory explanation. A member of CORADCOM's legal staff told us that provisions are routinely included in cost-type contracts covering cost-sharing agreements. The Chairman of the Board of Awards, CORADCOM, in reviewing the proposed award, asked about including a cost-sharing clause in the contract. The legal advisor said that the contract specialist would include a provision in the memorandum of negotiation addressing cost-sharing agreements. We were unable to determine what the provision was to include, but we found that it was not placed in the memorandum of negotiation. Furthermore, no clause was included in the contract. As a result, the Government did not protect itself from any potential overruns occurring on this contract even though the contractor offered such an arrangement.

2. On January 17, 1980, one of three offerors submitted to CORADCOM its original price proposal, totaling $1,391,986, for manufacturing method and technology to establish the automated production processes for three color-light-emitting diode display modules. After evaluating all proposals, the Government determined that this offeror was the only one with a "technically acceptable" approach. On June 3, 1980, the offeror submitted a revised proposal of $531,288; estimated costs and the fee were reduced by $848,033 and $12,665, respectively. The offeror said that the reason it chose to absorb the costs was the present, and almost unlimited, future potential of the program.

On August 5, 1980, CORADCOM awarded to the offeror a cost-plus-fixed-fee contract for $497,000. The contract included no provision to prevent the contractor from billing the Government for the $130,501 the contractor had proposed to absorb in the event costs incurred on the project exceeded the negotiated amount. The contracting officer agreed that such a clause had not been included in the contract, but he stated that no specific regulation existed that required him to include a clause of this type in the contract. We do not believe that this is a satisfactory explanation. Neither the Board of Awards nor the Legal Division commented on the lack of a cost-limiting clause.

Due to the contracting officer's failure to include a contract clause which would have made the contractor responsible for the first $130,501 of any cost overrun, the Government's interest is not adequately protected.

3. On March 8, 1978, one of two offerors submitted to ERADCOM its proposal, totaling $4,762,460, for advanced development and engineering development of a field artillery meteorological acquisition system. In reviewing the offeror's proposal, the Defense Contract Audit Agency reported that the overhead rates were acceptable. The agency further stated that the engineering overhead rate of 105 percent and the offeror's proposed general and administrative expense rate of 13 percent were significantly lower than its recently experienced rates. The agency suggested that rates proposed for engineering overhead and general and administrative expenses be established as a ceiling to reduce the risk to the Government of a cost overrun.

On March 13, 1979, ERADCOM awarded to the offeror a cost-plus-incentive-fee contract for $2,787,764, including rates as proposed, for advanced development. The basis for the award was that the offeror had the best technical, management, and cost proposal. No provision was included in the contract to limit engineering overhead and general and administrative expense rates to those proposed. Later, the contract was increased to $4,882,602 to include engineering development.

In January 1980, about 9 months after the contract was awarded, the contractor submitted a cost-growth proposal for an additional $5,656,463. In this proposal, the contractor used an engineering overhead rate of 124 percent and general and administrative expense rate of 25.4 percent which were substantially higher than those initially proposed and negotiated. We determined that the portion of the cost growth attributable to the differences between the engineering overhead and general and administrative expense rates originally proposed and the current proposed rates was almost $1.4 million. This proposal was negotiated and the contract was amended on August 18, 1980. We believe that the contracting officer could have protected the Government from some, if

not all, of the increased overhead rates had he negotiated a ceiling on the rates as suggested by the Defense Contract Audit Agency. Although the contractor's low cost proposal was the deciding factor in awarding the contract, the contracting officer failed to bind the contractor to its offer.

In discussions with a member of the negotiation team, the member admitted that the contracting officer should have included a ceiling clause in the contract. However, the Chief, Contracts Office, said that, as a matter of principle, he objected to including ceiling clauses in incentive-type contracts because the clauses place a fixed amount on what is the contractor's incentive. He also said that if he wanted to negotiate a ceiling clause with one bidder, to be fair, he should do it with all bidders.

We believe, however, that a ceiling could be beneficial because it would increase the incentive to the contractor to control overhead costs. By being permitted to propose increases in engineering overhead and general and administrative rates, the contractor had to absorb only 20 percent of the increase under the incentive provisions of the contract. Had the contract included a ceiling on these costs at the contractor-proposed rates, the incentive to control these costs would have been substantially increased since the contractor would have lost a dollar of fee for each dollar of overrun in these costs.

The Chairman, Board of Awards, offered no rationale as to why the board did not comment on the issue except to say that it was the contracting officer's responsibility. A legal advisor said he did not know why the legal review did not identify the problem, but he did say negotiation of an overhead limiting clause is a business, rather than a legal decision, and therefore, is the contracting officer's responsibility.

4. On August 3, 1976, an offeror submitted to CORADCOM a price proposal totaling $6,474,299 for engineering development models of a battery computer system. On September 14, 1976, the offeror submitted its best and final offer which reduced the estimated price by $260,655 to $6,213,644. Included in the price was $3,723,644 to be absorbed by the offeror. The reason given by the offeror for the cost absorption was that it was a corporate decision.

On September 28, 1976, CORADCOM awarded to the offeror a cost-plus-incentive-fee contract for $6,213,644. The basis for the award was the offeror's outstanding technical record. The contract provided that the offeror's share of the $6,213,644 was $3,723,644 and that the Government's share was $2,490,000. We believe that this case was properly negotiated and represents the way the preceding contracts should have been negotiated.

5. Over 30 companies were solicited to bid on the terrain simulation system. This procurement was to be a one-time buy for research and development with no production planned. Only one offeror submitted to CORADCOM its proposal for $989,849. The offeror's proposal was considered acceptable.

On June 11, 1980, the auditors reported that the offeror had not requested cost of money and that the contract should include a clause that facilities' capital cost of money not be considered an allowable expense for this contract. The offeror included the clause in the proposal, and on July 15, 1980, submitted a revised proposal for $921,260, which was the price negotiated on July 17, 1980. On August 13, 1980, CORADCOM awarded to the offeror a cost-plus-fixed-fee contract for an estimated $921,260.

We believe that these cases show that there is a need for greater care in negotiating contracts where either contractors propose cost-sharing arrangements or auditors recommend limiting overhead rates to prevent the Government from unnecessarily absorbing additional costs in cases of overruns. We also believe that there is a need for improved supervision and management review.

RECOMMENDATION

We recommend that the Secretary of the Army direct DARCOM to have its subordinate commands, CORADCOM and ERADCOM, emphasize to contracting officers their responsibilities to protect the Government's interests when (1) contractors either offer cost sharing arrangements or agree to absorb costs or (2) auditors report that offerors' proposed overhead costs appear to be too low. We also recommend that, in the future, the Legal Division and Board of Awards withhold approval until these concerns are properly addressed.

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As arranged with your Office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of the report. Then, we will send copies to the Secretary of the Army in order for him to comply with section 236 of the Legislative Reorganization Act of 1970.

Sincerely yours,

Clerio P. Pui

Acting Comptroller General
of the United States