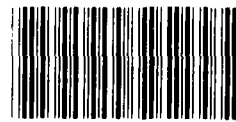


GAO

April 1986

PROCUREMENT

The Use of Unpriced Options and Other Practices Needs Revision



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United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-217655

April 23, 1986

The Honorable Caspar W. Weinberger
The Secretary of Defense

Dear Mr. Secretary:

This report summarizes the results of our review of contracting practices used by the military services to award, extend, and renew large multifunction or "umbrella" contracts for base support services. We decided to review these contracting practices because of the substantial value of the umbrella contracts.

This report contains recommendations to you in chapters 2 and 4. As you know, 31 U.S.C. 720 requires the head of a federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Secretaries of the Army, Navy, and Air Force; the Chairmen, House Committee on Government Operations, Senate Committee on Governmental Affairs, and House and Senate Committees on Appropriations; and the Director, Office of Management and Budget.

Sincerely yours,

Frank C. Conahan
Director

Executive Summary

The military services used 64 "umbrella" contracts, valued at \$3.5 billion, for support services on military bases during fiscal years 1977 through 1983. Under this contracting approach, a contractor supplies a wide range of services rather than just a single service. The use of umbrella contracts grew from \$20 million in fiscal year 1977 to more than \$1 billion in fiscal year 1983, and GAO estimates that the number of military bases using such contracts could nearly triple by fiscal year 1988.

Umbrella contracts are often extended or renewed beyond the basic contract period. Because of the substantial value of the contracts, GAO decided to review the processes by which these extensions and renewals are made. The review addressed the following questions:

- Do the practices used to extend or renew umbrella contracts meet the requirements of procurement regulations?
- Is the effectiveness of competition being restricted by excluding umbrella contract extension or renewal periods from the evaluations for the initial contract awards?

Background

Under umbrella contracts, contractors provide such diverse support services as custodial work, lawn mowing, road and building maintenance, pest control, food preparation, and security. By using an umbrella contract, a military base can reduce the number of contracts it awards and administers and can concentrate responsibility for the work with a single contractor.

The umbrella contracts GAO reviewed usually (1) were competitively solicited and (2) contained provisions allowing the base to extend or renew the contract for 2 to 4 years (that is, up to four 1-year periods) beyond the initial award, which was usually for 1 year. This was done in one of two ways: through options or follow-on contracts. An option gives the government the right to extend a contract at a price agreed upon at the time the initial contract was awarded; a follow-on contract is a separate, new contract for which the price is noncompetitively negotiated with the incumbent contractor.

GAO collected information on all 64 umbrella contracts identified by the Department of Defense (DOD) as being in effect between fiscal years 1977 and 1983. Sixty-one of these contracts had provisions for extension or renewal.

Results in Brief

GAO found that the military services' use of extensions or renewals for umbrella contracts sometimes did not meet regulatory requirements. In a number of cases, unpriced options were exercised and follow-on contracts were awarded. Although such awards are noncompetitive contracts, contracting officers did not justify their use in writing, as required. As a result, the important benefits that competition is intended to achieve, such as equal opportunity for all to compete, assurance that prices are reasonable, or the increased incentive for improved quality or delivery, were foregone without justifying that this was appropriate.

The military services also restricted the effectiveness of competition obtained on initial awards in some cases, because they excluded the cost of option or follow-on years from consideration when the initial contracts were competitively awarded. Excluding these years from consideration lessens the assurance that the government has received a fair and reasonable price over the life of the contracting cycle.

Principal Findings

Use of Options

Of the 64 umbrella contracts GAO reviewed, 56 had option provisions. Of these contracts, 15 had options that were not priced when the initial contracts were awarded. The unpriced options for the 15 contracts have generally been exercised when the contracts have come up for extension and prices for the option periods have been negotiated subsequent to the award of the initial contracts. GAO conservatively estimated the value of these unpriced options at \$808 million, if all are exercised.

Procurement regulations, as interpreted in decisions of the Comptroller General, indicate that unpriced options are not valid options and that if they are exercised, the awards must be justified in writing as noncompetitive contracts. This requirement is apparently not widely understood; contracting officers told GAO they did not think such written justification was required. Exercising unpriced options without justifying them in writing, however, is not in accordance with regulations. (See ch. 2.)

Use of Follow-On Contracts

Of the eight umbrella contracts which did not have option provisions, five contained follow-on contract provisions for a total of 18 planned years of noncompetitive contracts. GAO conservatively estimated the

value of these follow-on years at \$246 million. All five were Air Force contracts. This method of renewing the initial contract is not being handled in accordance with procurement regulations.

The regulations require that noncompetitive contract awards over \$25,000 be justified in writing. According to the military command which awarded most of the follow-on contracts, these awards were not considered noncompetitive or justified as such because the prices of the awards were based primarily on the prices that were competitively negotiated at the time of the initial contract awards. However, under procurement regulations, these follow-on contracts constitute noncompetitive awards. Therefore, written justifications were required. (See ch. 3.)

Limitations on the Effectiveness of Competition

Of the 64 contracts GAO reviewed, 21 had option or follow-on years that were excluded from the evaluation for the initial competitive contract awards, although there was a substantial likelihood that these contracts would be extended or renewed. Therefore, the selection of these contractors was not based on proposed prices for all the years of expected performance. The periods competitively evaluated at the time of the initial awards were valued at \$556 million. GAO conservatively estimated the value of the periods excluded from the evaluations at \$1 billion.

Regulations allow options to be included in the evaluation for the initial award. However, the regulations do not require this practice for service contracts which are very likely to be extended. This lack of a requirement contributed to the exclusion of umbrella contract options from the evaluation for initial awards. In one instance that GAO found and previously reported, the government may have saved \$8.3 million by including all years of the contracting cycle, instead of just the initial period, in the evaluation for the initial competitive contract award. (See ch. 4.)

Recommendations

To ensure that contract awards for all years of the contracting cycle meet regulatory requirements and that competition for contracts is enhanced, GAO recommends that:

- The Secretary of Defense take action to require all contract options currently covered by procurement regulations to be priced when the contract is initially awarded. (See p. 21.)

- The Secretary of the Air Force stop the award of preplanned, noncompetitive, follow-on umbrella contract awards that have not been justified in writing, as required, and direct the Air Force to use multiyear contracts and/or priced options wherever appropriate. (See p. 29.)
- The Secretary of Defense take action to require that any option that is likely to be exercised to extend a service contract be evaluated as part of the initial award, unless it is determined that not evaluating the option is more advantageous to the government. (See p. 40.)

Agency Response

DOD stated that the draft report was both informative and constructive and concurred at least partially with all of GAO's findings, conclusions, and recommendations. Because GAO's audit "concerned the use of umbrella contracts for base support services only," DOD's principal concern was the potential for "inadvertent application" of the recommendations to contracts and contracting methodologies other than those for base support services. DOD also stated that GAO's definition of "priced" option requires change to be complete. DOD cited the actions it will take to implement GAO's recommendations as they relate to base support service contracts. Beyond this, DOD stated that it intends to examine Federal Acquisition Regulation coverage pertaining to options for all types of acquisitions and will consider GAO's conclusions during that review. (See pp. 22, 30, 41, and app. IV.)

GAO disagrees with three of DOD's comments. GAO does not believe that its recommendations relating to (1) pricing options when the contract is initially awarded and (2) evaluating service contract options that are likely to be exercised should be limited to base support service contracts. Neither does GAO agree that its definition of priced option needs to be changed as DOD suggested. GAO has revised its other recommendation in consideration of DOD's comments. (See pp. 22, 30, and 41.)

The Office of Federal Procurement Policy commented that it generally agreed with the thrust of GAO's recommendations. The Office also stated that all of the recommendations appear appropriate for inclusion in the Federal Acquisition Regulation and it is considering developing a policy letter to help accomplish this. (See pp. 22, 30, 41, and app. V.)

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Abbreviations

DAR	Defense Acquisition Regulations
DOD	Department of Defense
FAR	Federal Acquisition Regulation
GAO	General Accounting Office

Introduction

The Department of Defense (DOD) budgeted about \$27.7 billion in fiscal year 1985 to operate and maintain (that is, provide “support services” for) its many bases throughout the world. Base support services such as custodial work, lawn mowing, road and building maintenance, pest control, trash collection, food preparation, and security are provided either by an in-house work force—military and civilian—or by contract personnel.

When contractors are used they can be hired to perform single work functions, several functions, or all the contracted support services on a military base. At some bases, large multifunction contracts, called “umbrella” contracts, provide a broad range of support functions. These functions may be provided at one location or several locations. Umbrella contracts also provide such services as running a missile test range, a developmental test center, or a troop training facility. The contracts have usually been awarded for a 1-year period and have included either contract options or follow-on contract provisions to extend or renew the initial contract for up to four 1-year periods.¹ The initial contract awards and the extension or renewal periods generally cover a total of 3 to 5 years, which this report refers to as the contracting cycle. Through an umbrella contract, a military base can reduce the number of contracts it needs to award and administer and can concentrate the responsibility for the work with a single contractor.

Use of Umbrella Contracting Has Increased and Is Expected to Rise Further

In fiscal year 1983, the last year covered by the contracts we reviewed, DOD funded² about 6,000 contracts totaling \$2.4 billion for base support services. Most of these contracts were relatively small, covering one function. The 45 fiscal year 1983 umbrella contracts³ were funded at about \$1 billion. For fiscal years 1977 through 1983, about \$3.5 billion was funded for 64 umbrella base support contracts.⁴ As figure 1.1 shows, the funded value of annual umbrella contract awards grew from

¹Options and follow-on contracts are defined and discussed in chapters 2 and 3, respectively.

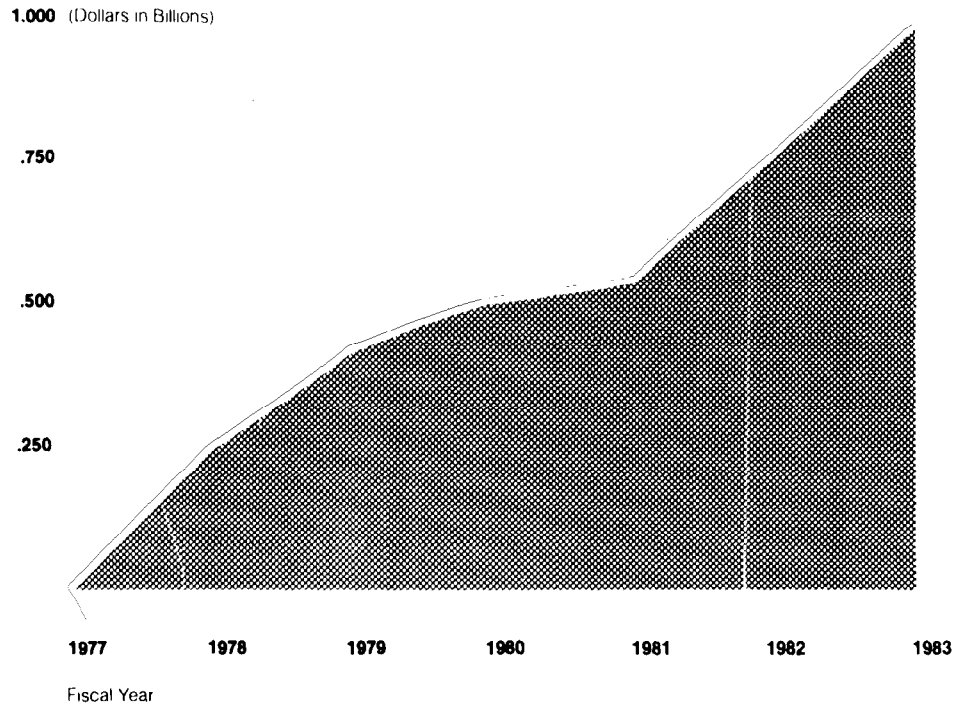
²“Funded” refers to money obligated as reported on DD Form 350, a reporting instrument used to collect data on contract placement within DOD for the Federal Procurement Data System. Obligations are transactions that require payment during the same or a future fiscal year. The Federal Procurement Data System, the official federal procurement data base, was established by Public Law 93-400, 88 Stat. 796, as a means for collecting, developing, and disseminating procurement data to meet the needs of the Congress, the executive branch, and the private sector.

³In 1983, the 45 ongoing umbrella contracts covered 42 military bases. One base had its work divided into two umbrella contracts and another base had its work divided into three umbrella contracts.

⁴Of the 64 umbrella contracts, the Air Force awarded 41, the Navy 12, and the Army 11.

\$20 million in fiscal year 1977 to over \$1 billion in fiscal year 1983. The individual umbrella contracts ranged from under \$1 million to over \$100 million a year.

Figure 1.1: Use of Umbrella Contracts for Base Support Services Has Increased Greatly



In fiscal year 1977, umbrella contracts for support services at military bases were funded for about \$20 million. By fiscal year 1983, that amount had risen to more than \$1 billion. GAO estimates that the number of umbrella contracts could nearly triple by fiscal year 1988.

Office of Management and Budget Circular A-76 provides policy guidance to federal agencies for determining whether commercial and industrial type work should be done by contracting with private sources or by using government personnel. Although the Office of the Secretary of Defense directs DOD's A-76 program, the individual military services determine which specific activities being performed by government personnel should be reviewed for possible contracting with private sources.

In keeping with the increased use of umbrella contracting for base support services during the 7-year period ending in fiscal year 1983, our

estimates show that more than 80 additional umbrella contracts could be awarded through fiscal year 1988. These estimates are based on the information the three military services provided to the Congress concerning the A-76 cost studies they propose to perform, as required by section 502 of the DOD Authorization Act of 1981, as amended. If all are awarded, the number of umbrella contracts could increase from 45 to more than 125. The decisions on whether to make awards to contractors or to keep the work in-house are expected to be based on the A-76 cost studies. The dollar amounts involved could be sizeable because some very large bases are being considered for contracting out.

Objective, Scope, and Methodology

Our overall objective was to evaluate whether the contracting practices the military services used in awarding umbrella contracts for base support services adhered to sound contracting policies and procurement regulations. Our work covered a number of different aspects of contracting procedures. Because of the size of the project, we plan to present the results of our work in two reports—this one dealing with the use of contract options and follow-on contracts and a second one dealing with the types of contracts, source selection evaluation criteria, and work statements used. For this report, we sought to satisfy our overall objective by determining whether:

- option provisions to extend umbrella contracts met the requirements of procurement regulations and the Comptroller General's decisions interpreting these regulations to price all options at the time of initial or underlying contract awards (see ch. 2);
- follow-on contracts used to renew umbrella contracts met the requirements of procurement regulations (see ch. 3); and
- the effectiveness of competition was being restricted in awarding umbrella contracts by excluding planned continuation periods from the evaluations for the initial, competitive contract awards (see ch. 4).

The Defense Acquisition Regulations (DAR), which applies to defense contract solicitations issued on or before March 31, 1984, and related contracts, spells out the rules covering those DOD procurements. DAR provided the basic criteria used in this review because it was in effect at the time all of the contracts we reviewed were solicited and awarded. This regulation includes requirements regarding matters such as obtaining competition, extending contractors' periods of performance by means of options or multiyear contracts, evaluating options at the time of the

underlying contract award, and exercising options. The Federal Acquisition Regulation (FAR) was recently developed to provide a uniform regulation replacing DAR as well as the Federal Procurement Regulations and the National Aeronautics and Space Administration Procurement Regulation. FAR and the DOD FAR Supplement, which both took effect on April 1, 1984, govern solicitations issued on or after that date.

We performed our work at the Office of the Secretary of Defense, the headquarters of the military services, and at nine U.S. military contract locations (seven in the United States and two overseas) that awarded umbrella contracts. The nine consisted of three Army, two Navy, and four Air Force locations in the United States, Greenland, and Turkey. In all, these locations had 17 of the 64 umbrella contracts⁵ included in our review. Our field work was performed between November 1983 and November 1984. In visiting field locations, we reviewed contract files and discussed our objectives and related questions with contracting officers and other appropriate agency officials.

We selected these nine locations for detailed review to obtain a mix of military services, different contractors, and contract types, as well as a variety of supplies and services and geographical representation.

To supplement this work, we sent questionnaires to contracting officers for the 64 umbrella base support contracts included in our review, which were awarded between fiscal years 1977 and 1983. We did so to obtain information for these contracts on such matters as the number of priced options at the time of the initial contract award and the other specific objectives listed above. The questionnaires were pretested with contracting officers at three military bases. We received responses on 100 percent of the contracts. A listing of all contracts included in our review is shown in appendix I.

Since we collected information on the 64 umbrella contracts by questionnaire, we did not visit all of the contract locations nor review all contract files. We also did not assess the accuracy or reliability of the DD Form 350 contract reporting system because the funding data obtained from the form was only used for background information.

We reviewed procurement regulations and the Comptroller General's decisions interpreting these regulations to determine whether unpriced

⁵DOD officials provided us with a listing of all umbrella contracts they could identify for fiscal years 1977-1983. We obtained data on each of these 64 contracts.

options included in underlying contracts are valid options. Based on a review of questionnaire responses and supporting documentation from contract files, we determined whether each umbrella contract contained priced or unpriced options at the time the underlying contract was awarded. For those underlying contracts containing unpriced options, we had discussions with and sent follow-up letters to cognizant contracting officials to determine (1) why options were not priced and (2) for those unpriced options that had been exercised, whether written justifications supporting noncompetitive awards were prepared.

To assess whether current practices relating to options and follow-on contracts restricted competition or its effectiveness, we (1) reviewed questionnaire responses and supporting documentation from contract files, (2) determined whether all planned out-years in the contracting cycle to extend umbrella contracts were included in the evaluation for award of the underlying contracts, and (3) reviewed procurement regulations, Comptroller General's decisions, and our past reports.

As we finished our work at the bases visited, we either discussed our findings with or presented written statements of fact to the officials responsible. Their comments, as well as the official agency comments in appendixes IV and V, were considered in compiling this report. Our review was performed in accordance with generally accepted government auditing standards.

Options Must Be Priced at the Time of the Initial Contract Award

Based on the Comptroller General's decisions interpreting procurement regulations, contract options, to be valid, must be priced at the time of the initial or underlying contract award. However, we found numerous instances in which options to extend base support service umbrella contracts were not priced at the time of the underlying award. Contracting officials frequently said they were not aware that options were required to be priced at that time.

Exercising an unpriced option after award of the underlying contract is, in effect, a noncompetitive (or sole-source) contract award. Procurement regulations require that such awards be justified in writing. However, for most of the unpriced options we reviewed that were exercised, the required written justification supporting a sole-source award was not prepared. As a result, the important benefits that competition is intended to achieve, such as equal opportunity for all to compete, assurance that prices are reasonable, or the increased incentive for improved quality or delivery, were foregone without justifying that this was appropriate. Contracting officials said they did not prepare sole-source justifications because they viewed the unpriced options as valid options.

We believe that to eliminate misinterpretation, the regulations should be revised to require contract options to be priced at the time of the underlying contract award. For existing contracts containing unpriced, unexercised options, written noncompetitive justifications should be properly supported and approved before the unpriced options may be exercised.

Unpriced Options Are Not Valid Options

Both DAR and FAR describe an option as a unilateral right in a contract, by which, for a specified time, the government may elect to purchase additional quantities of the supplies or services called for by the contract, or may elect to extend the period of performance of the contract.¹ Recognizing the government's need in certain service contracts for continuity of operation and the potential cost of disrupted support, the regulations allow options to be included in service contracts if there is an anticipated need for a similar service beyond the initial contract period. Fifty-six of the 64 base support service umbrella contracts on which we collected data contained option provisions. All 56 fell into this category of having anticipated needs for similar services beyond the initial, generally 1-year contract period.

¹ FAR subpart 17.2, which prescribes current policies and procedures for the use of option solicitation provisions and contract clauses, does not apply to contracts for services involving the construction, alteration, or repair of real property; architect engineer services; research and development services; automatic data processing equipment systems; and telecommunications equipment and services.

Although procurement regulations do not specifically state that an option must be priced at the time the underlying contract is awarded, they contain provisions which at least implicitly indicate that options should be priced at that time. For example, DAR 1-1502(a) states that "options require offerors to guarantee prices for definite periods of time with no assurance that the options will be exercised." In addition, the Comptroller General's decisions interpreting procurement regulations clearly indicate that options must be priced at the time the underlying contract is awarded. In three decisions,² the following points were made:

- an option is an unaccepted offer to sell upon agreed terms which may be unilaterally accepted by the government;
- an option should be clear and definite and should not require further negotiations to work out important and essential terms, including price;
- the option price must be agreed upon (that is, either fixed or finitely determinable) at the time the underlying contract is awarded; and
- if the option is not priced, there is no option for exercise by the government, and negotiation of the option price after the underlying award constitutes a resolicitation of the contract on a noncompetitive basis.

Based on these Comptroller General decisions, we believe that (1) if a contract option is to be valid, its essential terms (including price) must be agreed upon at the time the underlying contract is awarded and (2) if an option price is negotiated after the underlying contract is awarded, such a negotiation constitutes a resolicitation of the contract on a sole-source or noncompetitive basis. Consequently, the requirements relating to sole-source contracts apply. That is, an unpriced option exceeding \$25,000 may be exercised after the initial contract award if a sole-source award is justified in writing, as required by FAR 6.303-1. Regulations in effect for all the contracts we reviewed required examining the reasons for the procurement being noncompetitive, justifying the sole-source award in writing, and taking steps to foster competitive conditions for subsequent procurements.³

²Varian Associates, Inc. (B-208281, Feb. 16, 1983) 83-1 CPD 160; Department of Health and Human Services - Reconsideration (B-198911.3, Oct. 6, 1981) 81-2 CPD 279; and Pacificon Productions, Inc. (B-196371, July 22, 1980) 80-2 CPD 58.

³Current requirements for justifying the use of other than competitive procedures are set forth in the Competition in Contracting Act of 1984 (Public Law 98-369, July 18, 1984) and implementing regulations (FAR, Part 6). The act, which substantially changed previous procurement statutes and regulations, was intended to enhance competition and better limit unnecessary sole-source contracting. (See our report, Federal Regulation Need to be Revised to Fully Realize the Purposes of the Competition in Contracting Act of 1984 (Aug. 21, 1985, GAO/OGC-85-14) which explains the act's requirements and recommends changes to further strengthen federal regulations.)

Although option prices must be agreed upon at the time of the initial contract award, they do not necessarily have to be expressed as a specific dollar amount. Although firm fixed-price contracts will produce option prices of a specific dollar amount, other fixed-price and cost reimbursement contracts may provide formulas under which option prices or fees are finitely determinable, rather than stated in specific dollar amounts. For our review, we defined a “priced” option as a contractor’s guarantee, made at the time of the underlying contract award, to perform specified work under a contract option for

- a specific dollar amount, in the case of a firm fixed-price contract;
- an amount to be determined by applying provisions (or a formula) provided in the original contract but not including renegotiation of the price for this work, in the case of other fixed-price contracts; or
- a fee to be determined by applying a formula provided in the original contract, in the case of a cost reimbursement type contract.

Conversely, an “unpriced” option was defined as an option which is not priced at the time of the underlying contract award using the above criteria.

Many Contracts Contained Unpriced Options

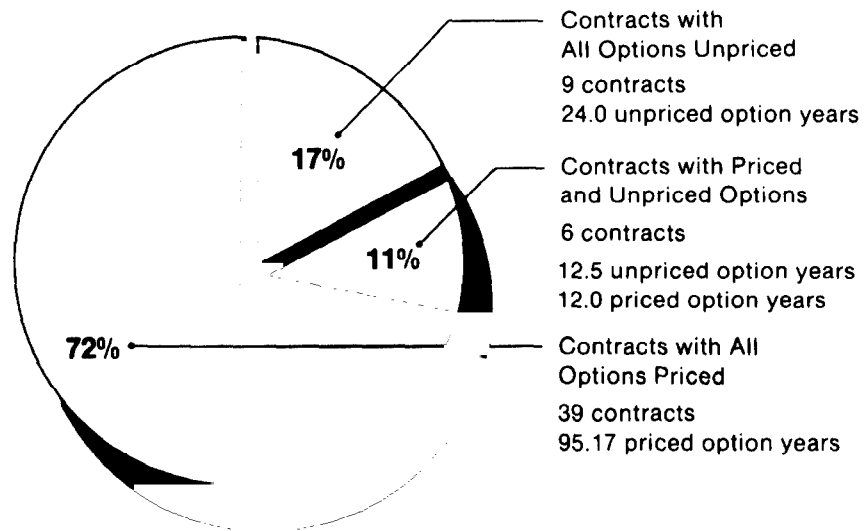
As of August 1984, 54 of the umbrella contracts⁴ in our review contained option provisions for a total of 143.67 years.⁵ Eighty-eight of these option years had been exercised and 55.67 were still exercisable.

As figure 2.1 shows, 39 contracts (72 percent) had all priced options, and 15 had either all unpriced options or a mixture of priced and unpriced options. In all, these 15 contracts contained provisions for 36.5 unpriced option years—25 percent of the total number of option years.

⁴Although 56 umbrella contracts contained option provisions, we excluded 2 from our analysis because they were terminated before any of their 5 option years could be exercised. In addition, 5 other option years from the remaining 54 contracts had been determined to be unexercisable at the time of our review. Therefore, a total of 10 option years (3 priced and 7 unpriced) originally included in the underlying contract awards were not included in the 143.67 option years total.

⁵Options generally were for 1 year. However, two contracts each contained provisions for fractional option years; one for 1/2 year and the other for 1/6 year.

Figure 2.1: One-Fourth of the Option Years Were Not Priced When Umbrella Contracts Were Initially Awarded



GAO collected data on 54 umbrella contracts that had options to extend performance beyond the period of the underlying contract award. Of the 54 contracts, 15 had options that were unpriced when the contract was first awarded. Of the total of 143.67 option years in the contracts, 36.5 years (25 percent) were unpriced when the contract was initially awarded.

Of the unpriced option years, 21 had been exercised and 15.5 were still exercisable. Prices for the 21 unpriced option years were negotiated noncompetitively with the existing contractors after the initial or underlying contract was awarded. Each of the three services had contracts with unpriced option years as indicated in table 2.1.

Table 2.1: Number of Contracts With Unpriced Options and Related Information by Military Service

	Number of contracts with unpriced options	Number of unpriced option years	Number of unpriced, exercised option years
Air Force	7	14.5	8
Army	3	8.0	6
Navy	5	14.0	7
Total	15	36.5*	21

*If exercised and if the rate of spending for the unpriced option years is the same as for their initial contract awards, the estimated value of these 36.5 option years would total \$808 million. We used this conservative estimating method because actual cost data were not available for most of the unpriced option periods. For the three contracts in which actual funding data for the entire contracting cycles were available, the actual value of the unpriced options exceeded our estimated value by \$117.4 million, or 30 percent.

Reasons Why Options Were Unpriced

We asked officials in each of the services why options were unpriced. Of the 15 contracts, 5 containing provisions for 14 unpriced option years at the time of the underlying contract award were Navy contracts awarded by the Naval Facilities Engineering Command. Contracting officers cited the following reasons why the 14 option years were unpriced at the time of initial contract award:

- Difficulty in projecting the scope of work due to uncertainties stemming from new base construction (three contracts with 10 option years).
- Uncertainties about inflation and the difficulty of projecting the scope of work as far out as the fourth and fifth years of a 5-year contracting cycle (two contracts with 4 option years).

It is important to note that each of these contracts anticipated a 5-year contracting cycle in spite of (1) the expressed uncertainties of projecting the scope of work that far into the future and (2) the prohibition in the Naval Facilities Engineering Command's 1979 contracting manual against including options to extend a service contract beyond a total period of 3 years.⁶

⁶One of the five Navy contracts was awarded in 1977, before the issuance of the 1979 contracting manual.

Of the 15 contracts with unpriced options, 7 were Air Force contracts. For six of the seven,⁷ which had provisions for 10.5 unpriced option years at the time of underlying contract award, contracting officers said that the primary reason for not pricing these options was the uncertainty of committing to a price, especially as far out in the contracting cycle as the fourth and fifth years.

Three of the 15 contracts, with provisions for a total of 8 unpriced option years, were Army contracts. Contracting officials cited the lack of definitiveness in the statements of work as a reason for not pricing these options at the time of initial contract award.

In summary, the reasons most frequently offered by contracting officials for not pricing the options at the time of the underlying contract award were that (1) the contract's statement of work could not be sufficiently defined or (2) the options were planned too far into the future.

In addition, we found that contracting officials believed that procurement regulations permitted use of unpriced options. Of the 10 contracting officials we questioned who were involved with the 15 contracts with unpriced options, 8 said they were unaware of any regulatory requirement precluding the use of unpriced options. Although the other two officials said they believed an unpriced option to be invalid, they were administrative contracting officers and were not involved in the original award of these contracts. However, in a letter we obtained relating to one umbrella contract, the command recognized that an unpriced option was a noncompetitive award and advised the contracting officer not to exercise it. We believe these varying interpretations indicate that the regulations need to be revised to clearly state that options are required to be priced at the time of underlying contract award.

⁷The administrative contracting officer for the seventh contract (a Small Business 8[a], negotiated, noncompetitive contract) with provisions for 4 unpriced option years was unable to provide a rationale as to why the options were unpriced. However, FAR 6.001(b) exempts 8[a] awards from the requirement to obtain competition. The Administrator of the Small Business Administration is authorized under section 8[a] of the Small Business Act (15 U.S.C. 631), as amended, to help small businesses which are owned and controlled by socially and economically disadvantaged persons. The agency enters into procurement contracts with other federal agencies and subcontracts the work to disadvantaged small businesses.

Written Sole-Source Justifications Were Generally Not Prepared When Unpriced Options Were Exercised

For the 15 umbrella contracts containing provisions for unpriced options, 21 unpriced option years in 11 contracts had been exercised as of August 1984. Contracting officials told us that for 19 of the 21 unpriced option years exercised, no sole-source justifications had been prepared.⁸

Even though written justifications were not prepared in most instances, we recognize that the circumstances surrounding a noncompetitive award may have justified it. In such cases, our Office has viewed the lack of a written justification as an error that does not invalidate the award if the surrounding circumstances indicate that the award was justified. To determine whether procurement officials believe that sole-source awards were appropriate, we sent letters asking procurement officials for each of the 21 unpriced option years that had been exercised whether a valid sole-source reason existed and, if so, what the valid reason justifying the sole-source award was.

We received responses to our letters covering 10 of the 11 contracts and 19 of the 21 unpriced, exercised option years. For eight contracts covering 15 unpriced, exercised option years, contracting officials did not directly respond to the questions. Instead, they indicated that they believed the procurement regulations did not require the use of a sole-source justification in order to exercise an unpriced option. For example, one contracting official said that

"... it is premature to address the questions in your letter concerning sole-source justification until we determine that the options were improper under DAR provisions. In the absence of DAR or statutory prohibitions against unpriced options, we do not believe the option must be repriced in all instances."

For the remaining two contracts covering 4 unpriced, exercised option years, contracting officials responded by saying that valid sole-source reasons did exist. They said that both contracts involved the provision of base support services during the early stages of base development and construction, making the scope of work uncertain.

If the contract options could not be priced at the time of the underlying contract award, we believe the option provisions should have been

⁸We did find one contract for which the contracting official said that written noncompetitive justifications had been prepared to support the exercise of two unpriced options. We were able to obtain one of the justifications. The other justification could not be found. Although we believe these two options should have been priced at the time of the underlying contract award, the contracting officer did recognize the need to rely on sole-source authority to exercise these unpriced options.

excluded from the solicitations and the contracts.⁹ New noncompetitive solicitations could have been issued for subsequent base support service needs, if sole-source awards could have been appropriately justified. Preplanned, noncompetitive awards, based on the exercise of unpriced options, need to be avoided.

Contracting officials responsible for 10 of the 11 contracts with unpriced option years already exercised said they considered their unpriced options to be valid and saw no need to follow sole-source procedures to justify exercising them. They said they based their authority to exercise the unpriced options on (1) contract clauses allowing extension of the contracts by exercising options and (2) regulatory provisions outlining requirements to be followed for doing so. However, since negotiation of an option price after the underlying contract award constitutes a resolicitation on a noncompetitive basis, a written sole-source justification was required in these instances.

Conclusions

Based on the Comptroller General's decisions, all contract options currently covered by procurement regulations are required to be priced at the time of the initial or underlying contract award. Nonetheless, this requirement is not clearly understood, as evidenced by (1) the existence of unpriced option provisions in umbrella base support service contracts, (2) the failure to justify the exercise of these unpriced options as noncompetitive awards, although such decisions are required to be justified, and (3) comments from contracting officials.

Recommendations

To eliminate misconceptions relating to the need to price contract options and to help ensure that future option provisions are priced, we recommend that the Secretary of Defense take action to have FAR amended to clearly require that all contract options currently covered by procurement regulations be priced at the time the initial or underlying contract is awarded. We also recommend that the Secretary of Defense take the actions needed to ensure that, for contracts currently containing unpriced and unexercised options, written noncompetitive

⁹In a preaward protest involving a solicitation with unpriced options (Comptroller General decision, Amdahl Corp. (B-198911.2, Mar. 27, 1981) 81-1 CPD 231), Amdahl challenged the propriety of the solicitation's requirement for unpriced options that contemplated later negotiations of price. The Comptroller General held that unpriced options were little more than advance agreements to conduct negotiations on what is tantamount to a sole-source basis and should, therefore, be deleted from the solicitation before award of the contract.

justifications have been properly supported and approved before the unpriced options are exercised.

Agency Comments and Our Evaluation

DOD agreed that FAR should be changed to require base support service contract options to be priced. However, DOD indicated that it was not willing to apply this recommendation to all service contracts or to contracts for systems or supplies because we reviewed only umbrella contracts for base support services. Instead, DOD stated that it (1) intends to examine FAR coverage pertaining to options for all types of acquisitions and (2) will consider our conclusions during that review.

We agree that our review focused on umbrella contracts for base support services. However, as noted in this chapter, contracting officials involved with the contracts containing unpriced options believed that the procurement regulations, which apply to contract options for many kinds of supplies, systems, and services, permitted the use of unpriced options. Generally, they said they were unaware of any regulatory requirement precluding the use of unpriced options. We found that the regulations do not specifically state that contract options must be priced at the time the underlying contract is awarded. We believe that the lack of clarity in this regulatory provision was a primary factor contributing to the use of unpriced options.

All three of the Comptroller General's decisions cited on page 15, which clearly indicate that contract options (1) must be priced at the time the underlying contract is awarded and (2) cannot be exercised based on prices negotiated after that time without justifying a sole-source award, were made on contracts for other than base support services. The contracts procured power amplifier tubes, data processing equipment and related services, and a national mass media campaign relating to high blood pressure. Another Comptroller General decision involved unpriced options for design, engineering, fabrication, and installation of spacecraft altitude chambers.¹⁰

Because the regulatory provision that needs to be clarified applies to contract options for many kinds of supplies, systems, or services, the potential for misunderstanding and the need for clarification to prevent the use of unpriced options is not limited to base support service contracts. In addition, revising FAR to require base support service contract

¹⁰43 Comp. Gen. 451 (1963).

options to be priced, as DOD suggests, could lead some contracting officials to the mistaken impression that options for all other services, supplies, or systems are not required to be priced at the time of the underlying contract award. Therefore, rather than just taking corrective action for base support service contract options, we believe DOD should take preventative action relating to all contract options.

DOD did not agree that our definition of priced option is adequate. DOD stated that at a minimum the definition should be revised to include options that are subject to (1) economic price adjustment provisions, (2) changes to prevailing wage rates established by the Department of Labor, or (3) a ceiling price with downward negotiation only. DOD stated it would provide a definition of priced option for DOD-wide use and inclusion in FAR.

We agree that options subject to economic price adjustment provisions or changes to prevailing wage rates established by the Department of Labor should be included in the definition of priced. In fact, our definition already provides for this.¹¹ However, we do not agree that an option containing a ceiling price and permitting "downward negotiation only" meets the definition of a priced option. In Varian Associates, Inc., which has previously been cited, our Office concluded that the downward renegotiation of the option price (1) constituted resolicitation of the contract on a sole-source basis and (2) was improper because the sole-source decision had not been justified, as required.

DOD concurred with our second recommendation concerning the need for written noncompetitive justifications to be properly supported and approved before exercising unpriced options for those contracts currently containing unpriced and unexercised options. DOD said it would (1) issue a general policy statement to the military departments and defense agencies to this effect¹² and (2) process a FAR change through the

¹¹See our references in the definition included on page 16 to (1) "an amount to be determined by applying provisions (or a formula) provided in the original contract . . ." and (2) "a fee to be determined by applying a formula provided in the original contract . . ." Such provisions or formulas could include economic price adjustment provisions or references to prevailing wage rates established by the Department of Labor.

¹²The Assistant Secretary of Defense for Acquisition and Logistics sent a memorandum dated January 31, 1986, to the secretaries of the military departments and directors of the defense agencies regarding a draft of this report. The Assistant Secretary instructed them to take appropriate action to insure that (1) procurement activities are made aware that the exercise of existing unpriced options is a noncompetitive acquisition and (2) "the justification requirements of FAR 6-303 are to be fulfilled before such contractual actions for base support services are consummated."

Chapter 2
Options Must Be Priced at the Time of the
Initial Contract Award

Defense Acquisition Regulatory Council, which coordinates the development of FAR changes.

The Office of Federal Procurement Policy commented that it generally agreed with the thrust of all the recommendations in this report. It also stated that all of them appear appropriate for inclusion in FAR and it is considering developing a policy letter to help accomplish this.

Noncompetitive Follow-On Contracts Should Be Avoided

For a few umbrella contracts, officials within the Air Force have awarded preplanned, noncompetitive follow-on contracts as a means of (1) renewing contracts initially awarded competitively and (2) continuing the relationship with the incumbent contractors.¹ These follow-on contracts were awarded based on a policy of extended contractual coverage, developed within the Air Force. Under this policy an initial contract is awarded on a competitive basis (normally for 1 year), and up to four 1-year follow-on contracts may be subsequently awarded on a sole-source basis with the incumbent contractor. This policy is not discussed in procurement regulations. Although procurement regulations require noncompetitive awards to be justified in writing, no such justifications were prepared for these follow-on contracts.

Use of Follow-On Contracts

The extended contractual coverage policy does not appear to have had widespread use. Of the 64 DOD umbrella contracts included in our review, only 5 were awarded under its provisions. Of these, four were for the Air Force Air Training Command, and one was for the Air Force European Procurement Center.

The 5 initial contracts involved a total of 18 planned noncompetitive follow-on contracts of 1 year each. Under the provisions of the extended contractual coverage policy, the follow-on contracts represented separate, new, future contracts, and as such, the follow-on years were not priced as part of the initial (1 year) competitive awards. However, we conservatively estimated the potential value of the 18 noncompetitive follow-on contracts, if all are awarded, at \$246 million.²

The extended contractual coverage policy permits elimination of competitive solicitations for up to four additional 1-year periods after the initial competitive award, and does not require the contracting officer to prepare a noncompetitive justification for any of the future four 1-year periods. However, the award of follow-on contracts to the incumbent contractor is contingent upon negotiation of a contract that is fair and reasonable to the government. For like or similar work, the subsequent

¹"Follow-on contract" means a new, noncompetitive procurement placed with an incumbent contractor, either by a separate new contract or by a supplemental agreement, to continue or augment a specific military program, where such placement was necessitated by prior procurement decisions. An example is a contract award for production of a major weapon system to the contractor that developed the system when award to any other source would result in substantial duplication of cost to the government that is not expected to be recovered through competition.

²The estimating method used here was the same as that used to estimate the value of the unpriced options described in ch. 2.

year's contract price is not supposed to increase except where the incumbent contractor shows that a fair and reasonable increase is in order. Use of the policy is based, in part, on the belief that it will result in savings to the government through eliminating start-up costs and avoiding disruption of service in follow-on years. In addition, a contract official who still used the policy said that inability to sufficiently define the scope of work beyond the initial 1-year contract award period precluded the use of options to extend the Training Command's four contracts because the options would have been unpriced.

As of August 1984, 11 of the 18 follow-on contracts were eligible for award and all 11 had been awarded after noncompetitive negotiations with the incumbent contractors. The one Air Force European Procurement Center contract commenced October 1, 1976. At the end of a 3-year contracting cycle, the Center discontinued use of the extended contractual coverage policy because contracting officials regarded the follow-on contracts as sole-source awards. For the next competitively awarded contract in 1980, a contract containing four 1-year priced options was awarded.³

The Air Force Air Training Command was still using the extended contractual coverage policy as of December 1985. However, instead of using this policy, under which the contracting office plans at the beginning of the procurement to award follow-on contracts without the benefit of competition if the incumbent's negotiated price is determined to be "fair and reasonable," we believe that the use of priced options or other authorized procurement techniques, such as multiyear contracting, should be considered.⁴ Both multiyear contracts and contract options are required to be priced at the time of the initial contract award. If a noncompetitive follow-on contract is awarded because these other techniques are determined to be inappropriate, then a written justification for using other than competitive procedures must be prepared.

³The options were also included in the competitive evaluation for the initial contract award. (This subject is discussed in ch. 4.) Using this contracting technique, the Center was able to obtain and evaluate competitive proposals for its entire contracting cycle.

⁴A multiyear contract is a procurement consisting of requirements for up to a 5-year period without having total funds for the entire multiyear period available at the time of initial contract award. Solicitations for multiyear contracts require either annual and multiyear bids/proposals or only multiyear bids/proposals. Consequently, all years of the underlying multiyear contract award are priced and included in the evaluation for award. Before using a multiyear contract for base support services, the head of the agency must determine that (1) there will be a continuing requirement for the services, (2) furnishing the services will require a substantial initial investment in plant or equipment, and (3) the use of a multiyear contract will promote the best interests of the United States. (See 10 U.S.C. 2306 (g).) As noted in ch. 4, multiyear contracts have been awarded for base support services.

Follow-On Contracts Not Justified as Noncompetitive

Before an agency may negotiate a noncompetitive procurement exceeding \$25,000, procurement regulations require that a written justification be provided adequately supporting the need for a sole-source procurement. However, the 11 noncompetitive follow-on umbrella contracts that had been awarded as of August 1984 were based on the extended contractual coverage policy which does not require written sole-source justifications.

Contracting officials at the Air Force Air Training Command said they have never viewed their follow-on contracts under the extended contractual coverage provisions to be noncompetitive. The Director of Contracting stated:

"It is made clear to offerors that follow-on contract prices will not increase from the competitive price, except where the contractor can conclusively show that fair and reasonable increases are in order. Thus, follow-on contract prices are actually based on the price obtained in the competitive year."

The Director also said that contract actions of this type are considered competitive within the framework of the Federal Procurement Data System.⁵

We disagree with the Air Training Command. Like the European Procurement Center, we believe that each follow-on contract negotiated with the incumbent, after the initial competitive contract has been awarded, is a noncompetitive or sole-source award. Even though it may be clear to offerors that the awardee of the initial contract must limit the price of follow-on contracts to only fair and reasonable increases from the competitive base year price, the fact remains that the price for each follow-on year is subject to negotiation without competition. Labeling a contract as "follow-on after competition" does not make it competitive. Furthermore, we note that the Federal Procurement Data System classifies such contract actions as noncompetitive, not competitive.⁶

If a procurement is not genuinely competitive, the government has less assurance that contract prices are fair, reasonable, and consistent with potentially available market prices. Procurement regulations in effect at

⁵See DAR 21-106.5 for DD Form 350 reporting requirements related to the extent of competition on DOD contract awards. Also, see footnote 2, ch. 1.

⁶In one of our reports (GAO/PLRD-82-45, Mar. 8, 1982), we questioned DOD's portrayal in congressional testimony of follow-ons after competition as competitive. In commenting on the report, DOD concurred that such follow-on contracts are noncompetitive.

the time these follow-on contracts were awarded stressed the importance of basing contract awards on competition to the maximum practical extent.⁷

Conclusions

Contract renewals by means of noncompetitive follow-on contracts did not meet regulatory requirements because the need for noncompetitive procurements was not justified in writing, as required. Further, to convert such follow-on contracts to competitive ones, all planned continuation (or follow-on contract) years in the contracting cycle should be included in the initial competitive contracts by means of multiyear contracting and/or priced options.

If the scope of base support service work is so uncertain for the continuation (or follow-on) periods as to preclude reasonable pricing at the time of the initial award, we believe the planned follow-on years should not be included in the contracting cycle. Further, such procurements should be based upon competitive resolicitations, unless a noncompetitive award is justified in writing and approved in accordance with legal requirements.

Recommendation

We recommend that the Secretary of the Air Force not permit the use of preplanned, noncompetitive, follow-on contracts for base support services based on the extended contractual coverage provisions. Instead, we recommend that the Secretary require all planned continuation periods (follow-on years) for base support service contracts to be included in the initial contracts by means of multiyear contracts and/or priced options. If the scope of work for these continuation periods is so uncertain as to preclude reasonable pricing at the time of initial contract award, such periods should not be included in the contracting cycle; instead, procurements for such periods should be based upon competitive resolicitation, unless a sole-source award is justified and approved in accordance with legal requirements.

⁷As noted in ch. 2, these requirements were substantially changed, based on the Competition in Contracting Act of 1984, to enhance competition and better limit unnecessary sole-source contracting. In fact, the House and Senate Conference Committee report on the act states that only certain contracts for major systems or highly specialized equipment may qualify as legitimate follow-on, sole-source contracts based on the circumstance that they are "available from only one responsible source and no other type of property or services will satisfy the agency's needs." (House Report No. 98-861, 98th Cong., 2nd Sess. (1984).) See FAR 6.302-1 (a)(2)(ii) as amended by Federal Acquisition Circular 84-13, effective February 3, 1986.

Agency Comments and Our Evaluation

DOD concurred with this recommendation in so far as it applies to base support service contracts. DOD suggested that the recommendation in our draft report be revised to indicate more clearly that it applies only to base support service contracts. We agree and have clarified the recommendation. DOD also stated that our recommendation is basic policy for base support service contracts and it would be reemphasized by letter to the military departments and defense agencies.⁸

The Office of Federal Procurement Policy stated that (1) it generally agreed with the thrust of all the recommendations in this report and (2) they all appear appropriate for inclusion in FAR. The Office suggested that we direct the recommendation in this chapter to the Secretary of Defense, instead of the Secretary of the Air Force, to conform to the other recommendations in this report to amend and clarify FAR. We have not done so because (1) we identified the problem which this recommendation is intended to correct as existing only in Air Force contracts we reviewed and (2) we do not believe FAR needs to be revised to correct it. However, as indicated above, DOD has agreed to take preventative as well as corrective action by reemphasizing this recommendation as basic policy to all three military departments and the defense agencies.

⁸The Assistant Secretary of Defense for Acquisition and Logistics stated DOD policy on the matters discussed in this chapter in a memorandum dated January 31, 1986, to the secretaries of the military departments and directors of the defense agencies.

Excluding Continuation Periods From the Initial Award Evaluation Makes Competition Less Effective

By exercising contract options or awarding noncompetitive follow-on contracts, the Army, Navy, and Air Force either extend or renew most umbrella base support service contracts beyond the period of the initial contract award.¹ We found that even though there was a substantial likelihood that these contracts would be extended or renewed, in the case of 21 initial umbrella contract awards with provisions for extension or renewal, most of the continuation periods were not included in the evaluation for the initial award.

As a result, the effectiveness of competition was restricted for the unevaluated continuation periods and the government had less assurance that it had received fair and reasonable prices. We conservatively estimated the value of these unevaluated continuation periods to be \$1 billion. An important reason these periods were unevaluated was that most of them were not priced at the time of the initial contract awards. However, procurement regulations, which have permitted continuation periods to be excluded from evaluation for the initial contract awards, also contribute to this condition.

Even if our recommendation in chapter 2—requiring options to be priced—is implemented, existing regulations still need to be revised to ensure that options which are expected to be exercised are included in the evaluation for the initial contract award. This revision would provide greater assurance that the government is receiving fair and reasonable prices.

Initial Umbrella Contract Awards Are Almost Always Extended or Renewed

The military services normally have a continuing need for the support services provided under umbrella contracts. In awarding umbrella contracts for these support services, the three services generally used contracting practices that enabled them to retain contractors for longer than 1 year. In general, they (1) selected contractors through competitive negotiations, (2) awarded initial contracts for 1 year, and (3) included in the contracts provisions permitting the government to continue the period of the contractor's performance, in 1-year increments. Each out-year continuation was usually achieved either by exercising an

¹"Extending" a contract in this context refers to the government's election to purchase additional services under an existing contract through the exercise of an option. "Renewing" a contract refers to the government's election to purchase additional services called for by a contract through the award of a new, follow-on contract.

option to extend the original contract for the next year, or by negotiating a new follow-on contract for the next year. At the end of the contracting cycle, further procurement was usually based on a new competitive solicitation.

All but 1 of the 64 umbrella contracts we reviewed had a contracting cycle exceeding 1 year. For these 63 contracts, the following methods were used to obtain a contracting cycle which ranged from 2 to 5 years:

- Fifty-six contracts had initial contract awards (normally for 1 year) with one or more options (normally for 1 year each) for extending the contracts.
- Five contracts had initial contract awards (normally for 1 year) with extended contractual coverage provisions permitting the negotiation of up to four new 1-year, noncompetitive, follow-on contracts with the incumbent contractors.
- Two overseas contracts (Wake Island and Greenland) were awarded as multiyear contracts of 3 years' duration, without contract extension or follow-on contract renewal provisions.

The military services have generally extended or renewed incumbent contractors' initial contracts. As of August 1984, the initial contract period had not yet expired for 6 of the 61 contracts with provisions for extension or renewal. This left 55 contracts that could have been extended or renewed. For these 55 contracts, decisions had been made to extend or renew 53 (or 96 percent) for at least 1 continuation year. The extensions and renewals encompassed 99 (or 91 percent) of the 109 continuation years available for award through that date.²

²Decisions were made before August 1984 to never exercise 10 (or 9 percent) of the 109 continuation years. (App. II provides the reasons given for these decisions.) Also, for the 53 contracts, 46.67 additional continuation years were to become available for potential future extension or renewal after August 1984. Therefore, these were not counted as part of the 109.

The Effectiveness of Competition Was Unnecessarily Limited on Some Contracts

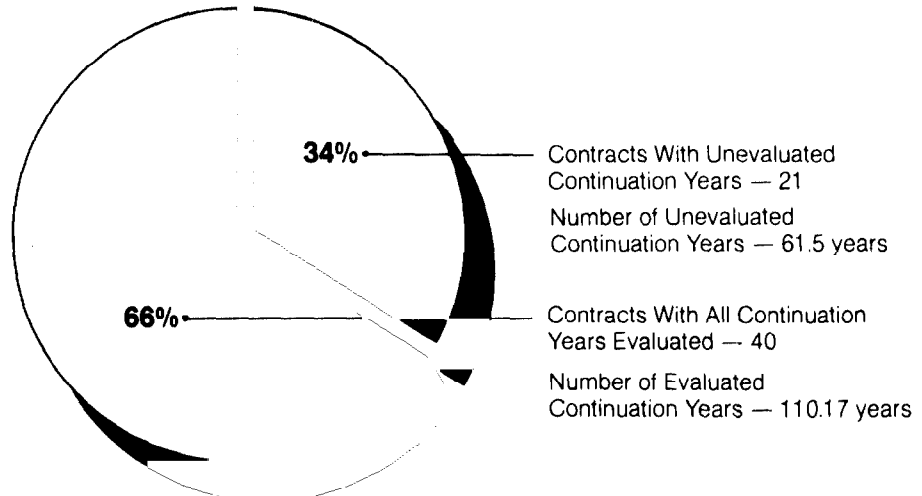
We found 21 initial awards of umbrella base support service contracts for which some or all of the out-years of the planned contracting cycle were excluded from the evaluation for the initial award.³ In all, 61.5 of the continuation years were unevaluated, as shown in figure 4.1. The 21 initial contract periods evaluated for the underlying awards were valued at \$556 million.⁴ If the same rate of spending were incurred for the planned continuation periods, the value of the continuations would total \$1.27 billion.⁵ Of this amount, an estimated \$1 billion (or 79 percent) was not included in the evaluations for the initial contract awards.

³FAR 15.6 prescribes policies and procedures for source selection in competitive negotiated acquisitions. It states that (1) proposal evaluation is an assessment of both the proposal and the offeror's ability (as conveyed by the proposal) to successfully accomplish the prospective contract and (2) among other purposes, source selection procedures are intended to maximize competition, ensure comprehensive evaluation of offerors' proposals, and ensure selection of the source whose performance is expected to best meet the stated government requirements.

⁴The estimated dollar value of the initial contract awards was obtained from either DOD officials' responses to our questionnaire or the contract price negotiation memorandum. These initial awards ranged from 1 month to 3 years in length. The two largest initial awards were for 3-year periods and were each priced in excess of \$100 million.

⁵We estimated the dollar value for the continuation periods (used in ch. 2 through 4) by extending to the continuation periods the same rate of spending as was estimated for their initial contract awards. This conservative estimating method was used because actual cost data was not available for most of the continuation periods. For the four contracts in which actual funding values for the entire contracting cycles were available, actual value exceeded our estimated value by \$122.8 million (or 31 percent).

**Figure 4.1: Many Continuation Years
Were Not Evaluated When Umbrella
Contracts Were Initially Awarded**



Although the military services continue most umbrella contracts beyond the period of the initial award, they do not always include all the planned continuation periods in the evaluations for these awards. Of the 61 umbrella contracts awarded in fiscal years 1977-1983 that had provisions for continuation, 21 (34 percent) had continuation years that were not evaluated. In all, 61.5 continuation years were not evaluated. GAO conservatively estimates that these unevaluated years were worth \$1 billion.

In 5 of the 21 contracts, options were not used as a means of extending the contracts. Instead, the five contracts had follow-on contract provisions based on the Air Force's extended contractual coverage policy. The five contained provisions for a total of 18 planned years of noncompetitive follow-on contracts with an estimated value of \$246 million. When awarded, these 18 follow-on years are separate contracts from the initial awards. Therefore, they cannot be priced nor included in the evaluation for the initial competitive contract awards. However, if our recommendation in chapter 3 is implemented, all planned continuation periods for base support service contracts will be included in the initial contracts by means of multiyear contracts and/or priced options. Therefore, it will be possible to include them in the evaluation for the initial contract awards.

Chapter 4
Excluding Continuation Periods From the
Initial Award Evaluation Makes Competition
Less Effective

The remaining 16 of the 21 contracts had option provisions. The 16 contracts contained 43.5 option years that were not included in the evaluation for the initial awards.⁶ The estimated value of these unevaluated years, based on the estimating method described above, is \$758 million. The 43.5 years represent 28 percent of the total of 153.67 option years in all 56 contracts with options.

Table 4.1 provides details, by military service, on the umbrella contracts with continuation years excluded from the evaluation for the initial award.

Table 4.1: Umbrella Contracts, by Service, for Which Some or All of the Planned Continuation Years Were Excluded From the Evaluation for the Initial Award

	Contracts with option years excluded	Number of option years excluded	Contracts with follow-on years excluded	Number of follow-on years excluded	Total contracts with continuation years excluded	Total continuation years excluded
Air Force	7	14.5	5	18	12	32.5
Army	3	10.0	0	0	3	10.0
Navy	6	19.0	0	0	6	19.0
Total	16	43.5	5	18	21	61.5

We found a strong correlation between the pricing of options and their inclusion in the evaluation for the initial award. That is, of the 56 contracts with options,

- 38 had only priced options that were included in the evaluation for the initial award and
- 13 had unpriced options that were not included.

However, two other contracts had only priced options that were not included in the evaluation for the initial award and another three contracts had unpriced options that were included.

⁶Of these 16 contracts, 6 contained a mixture of evaluated and unevaluated option years. In all, for the six contracts, 12.5 option years were excluded from and 12 option years were included in the evaluations for the underlying contracts. For the remaining 10 contracts, all 31 option years were unevaluated at the time of the initial contract awards. Of the 43.5 unevaluated option years, 37.5 (or 86 percent) were not priced at the time of the underlying contract awards. Of these 37.5 unpriced option years, 30.5 were included in our analysis in ch. 2, but the other 7 were excluded from that analysis, because their underlying contracts were terminated before any of the options could be exercised (also see footnote 4, ch. 2).

Effects of Not Including Continuation Periods in the Evaluation for Award

Not evaluating all the options in awarding umbrella contracts, even though a substantial likelihood exists that the unevaluated options will be exercised, means that (1) only contractor proposals relating to the initial evaluated period can affect the outcome of the competitive process and (2) the competitive pressures and incentives are not brought to bear to keep the option prices down. This raises questions about whether the government has adequate assurance that prices paid to continue contractor performance on umbrella contracts are fair and reasonable.

Including priced options in the evaluation for the underlying contract award can help protect the government from awarding a contract on the basis of an unrealistically low offer for the period evaluated only to have it followed by unrealistically high prices for subsequent unevaluated periods.⁷ For example, it may help eliminate government losses due to a "buy-in"⁸ on the initial contracting period. Although buy-ins are not illegal, DAR and FAR require the contracting officer to ensure that the contractor does not subsequently recover losses at the government's expense. If option periods are not included in the evaluation, the likelihood of being able to enforce this requirement is reduced where the government has a continuing need for the service and contract extension is expected.

The practice in awarding the majority of umbrella contracts we reviewed has been to include all options in the evaluation for award. Of the 56 contracts with option provisions, 40 included all 98.17 option years in the evaluation for award; 34 of the 40 were awarded based on an evaluation of 2 or more offers. We tried to determine whether the award of these 34 contracts would have gone to a different contractor if the evaluation for award had been based on the proposed price for only the first contract period rather than all periods of the contracting cycle.

Out of 15 contracts for which we had sufficient data to determine the offerors' prices for the first contracting period compared to their total prices for the whole contracting cycle, we found three examples that demonstrated the potential for greater cost to the government if all years of the contracting cycle are not included in the evaluation for

⁷In addition to the problems with unpriced options discussed in ch. 2, not pricing unevaluated options reduces the government's visibility over potential problems of unrealistically low offers.

⁸"Buying in" refers to the practice of attempting to obtain a contract award by knowingly offering a price or cost estimate less than the anticipated costs with the expectation of either (1) increasing the contract price or estimated cost during the period of performance on that contract or (2) receiving future follow-on contracts at prices high enough to recover any losses on the original buy-in contract.

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Excluding Continuation Periods From the
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award.⁹ In all three, a different contractor could have been selected if the effectiveness of the competition had been limited by basing the evaluation for award on the price proposals for the initial contract period rather than on proposals for the entire contracting cycle.

In one of the three examples we identified, the initial contract period was for 3 months, while the entire contracting cycle was for 4.33 years. As table 4.2 shows, if the government had awarded the contract based on the offer for only the initial period, the award would have been made to a firm that offered \$165,654 less than the firm that actually received the award. However, over the entire 4.33-year cycle, the losing firm's proposed price was \$8,715,116 more (8.4 percent of the total price) than the offer actually selected.

Table 4.2: Proposed Prices for the Initial Period Versus All Periods in the Contracting Cycle

	Proposed price for first period in the contracting cycle	Proposed price for all periods in the contracting cycle
Firm A	\$6,339,799	\$104,369,884 ^a
Firm B	6,174,145	113,085,000
	(Firm B is \$165,654 lower.)	(Firm B is \$8,715,116 higher.)

^aFirm A received the award, a firm fixed-price/award fee type contract.

The other two examples we found, which are discussed in appendix III, follow a similar pattern. They demonstrate that evaluating the whole contracting cycle can make competition more effective, leading to possible savings and greater assurance of fair and reasonable prices.

A similar demonstration was made in a prior report¹⁰ in which we found that the Air Force might have saved \$8.3 million (or 12.3 percent of the contract price) if it had been permitted to consider in the award evaluation each offeror's first year proposal combined with subsequent option prices for the second and third years of the contracting cycle.

⁹These examples merely illustrate the potential problem when some planned continuation periods are not evaluated. Since all the option years were included in the evaluation for these 15 awards, we believe this should have reduced the likelihood for offerors to submit unrealistically low offers for the initial periods in these cases.

¹⁰Potential Savings By Improving Evaluation of Competitive Proposals for Operation and Maintenance Contracts (B-162839, Apr. 25, 1969).

Regulatory Requirements Need to Be Revised

An important reason that continuation periods were unevaluated was that, as chapters 2 and 3 of this report show, many of them were not priced at the time of the initial contract awards. Of the 43.5 option years that were not evaluated, 37.5 were unpriced at the time of the initial awards. All 18 of the planned years of noncompetitive follow-on contracts were also unpriced when the initial contracts were awarded.

Although most of the priced options on the umbrella contracts we reviewed were included in the evaluations for the initial awards, the regulations do not require such options to be evaluated. Consequently, the use of priced options, as recommended in chapters 2 and 3, will not necessarily result in the options being evaluated whenever appropriate in awarding umbrella contracts for base support services. However, we recognize that in other circumstances not involving base support service contracting, such as the use of options for additional quantities of products that are unlikely to be exercised, it generally may not be appropriate to evaluate the options.

Because of the strong likelihood that options to extend umbrella base support service contracts will be exercised, pricing and including these options in the evaluations for the initial contract awards would generally improve the effectiveness of competition and could result in saving the government money. FAR, as presently written, does not specifically address the evaluation of options to extend service contracts. However, FAR 17.206 does outline steps that must be followed if options for additional quantities are to be considered in the evaluation for award. It states that before such an evaluation can occur, an authorized person at a level above the contracting officer must affirmatively determine that including options in the award evaluation would conform to expressed regulatory requirements. Although this requirement is appropriate for options that are generally not likely to be exercised, we believe FAR needs to be revised to specifically address the evaluation of options to extend service contracts. That is, FAR should provide that options to extend these contracts should generally be included in the evaluation for the initial award if there is a strong likelihood the option will be exercised.

FAR 17.206 also limits its discussion of including option quantities in the award evaluation to certain types of contracts—firm fixed-price, fixed-price with economic price adjustment, and fixed-price incentive fee. Options to extend service contracts should not necessarily be excluded

from the evaluation for award when cost reimbursement type¹¹ contracts are used. In fact, we found that 22 of the 40 umbrella contracts that included all options in the evaluations for the initial awards were cost reimbursement contracts. Only five cost reimbursement contracts did not have all their options evaluated for the underlying contract awards.

Conclusions

There was substantial likelihood that the need for the service would continue and that the incumbent contractor would be retained beyond the initial contracting period for the umbrella base support contracts we reviewed. However, we found 21 umbrella contracts in which the evaluation for the initial award was not based on contractor proposals covering all the anticipated years in the contracting cycle. Because part of the planned contracting cycle was excluded from consideration, we believe that the effectiveness of competition was limited and that the government had reduced assurance that fair and reasonable prices were achieved in these contracts.

Although FAR, as presently written, allows options to be included in the evaluation for award, we believe this practice is not emphasized strongly enough for service contract options which are likely to be exercised. This lack of emphasis was a primary factor contributing to the exclusion of options from the evaluation for initial award of base support service contracts. FAR 17.206 outlines steps that must be followed if options for additional quantities are to be considered in the evaluation for the initial award. This provision, or the related DOD FAR Supplement provision, needs to be revised to require that before an option which is likely to be exercised to extend a service contract can be excluded from the evaluation for the initial award, such action must be justified as being in the government's best interests. This regulatory provision should address including options in the evaluation for the initial award of cost reimbursement as well as fixed-price service contracts.

Recommendation

We recommend that the Secretary of Defense take action to have FAR 17.206 or the related provisions of the DOD FAR Supplement amended to

¹¹Including options in the evaluation for award of cost reimbursement contracts, as a practical matter, will have less significance than including them in the evaluation for award of firm fixed-price contracts. This is because (1) to the extent that options in cost reimbursement contracts are evaluated based on prices, only the fee is fixed and allowable costs are estimated at the time the options are evaluated, whereas for firm fixed-price contracts the total price to the government is known and (2) price is usually a less important factor in terms of the source selection evaluation criteria used in awarding cost reimbursement contracts.

require that, regardless of the type of contract used, all options which are likely to be exercised to extend any service contract be evaluated as part of the initial award, unless the contracting officer justifies in writing and receives higher level approval that not evaluating the options is more advantageous to the government. If the contracting officer has a reasonable basis for determining that the option is not likely to be exercised, then evaluating it should not normally be considered more advantageous to the government.

Agency Comments and Our Evaluation

DOD "partially concurred" with our recommendation, agreeing that all options which are likely to be exercised to extend base support service contracts, regardless of contract type, should be evaluated as part of the initial award, unless the contracting officer justifies in writing and receives higher level approval for not evaluating the options. DOD promised to take action to revise FAR coverage consistent to this position. DOD noted that our recommendation should not automatically apply to all service contracts because the findings on which it is based pertain only to base support service contracts. However, DOD stated that it intends to examine FAR coverage pertaining to options for all types of acquisitions and will consider our position during that review.

Although our examination of this subject was limited to umbrella contracts for base support services, we found that the lack of emphasis in procurement regulations on the practice of including service contract options in the evaluation for initial awards was an underlying cause of the problem. Therefore, the corrective action needed is to provide such regulatory coverage, and not limit it to only base support service contracts. If the regulatory coverage is limited to base support service contracts, those using it may feel justified in assuming that options likely to be exercised to extend service contracts other than base support services need not be evaluated. We believe that DOD's upcoming examination of FAR coverage pertaining to options for all types of acquisitions will confirm the need to apply our recommendation to all service contracts.

The Office of Federal Procurement Policy commented that it generally agreed with the thrust of all the recommendations in this report. The Office also stated that it is considering developing a policy letter intended to include this recommendation in FAR.

Sixty-Four Umbrella Contracts Reviewed

Contract number	Military facility/location
Army—11 contracts	
1. DAAE07-81-C-5002	Selfridge Air National Guard Base, Michigan
2. DACA31-80-C-0154	Vint Hill Farms Station, Virginia
3. DAAG60-81-C-0057	U S Military Academy, West Point, New York
4. DAAB07-82-C-C057	Fort Monmouth, New Jersey
5. DABT57-83-C-0009	Fort Eustis, Virginia
6. DAAG08-81-C-0001	Sacramento Army Depot, California
7. DAAJ09-80-C-5227 ^a	St. Louis Area Support Center, Illinois
8. DAAJ09-82-C-B907 ^a	St. Louis Area Support Center, Illinois
9. DABT11-80-C-0100 ^a	Fort Gordon, Georgia
10. DAKF04-81-C-0006 ^a	Fort Irwin, California
11. DAAA09-80-C-3011	Hawthorne Army Ammunition Plant, Nevada
Navy—12 contracts	
12. N62474-81-C-8529 ^a	Naval Weapons Center, China Lake, California
13. N62474-82-C-0051 ^a	Naval Weapons Center, China Lake, California
14. N62474-77-C-2410 ^a	Naval Submarine Base, Bangor, Washington
15. N62474-81-C-8831 ^a	Naval Submarine Base, Bangor, Washington
16. N62467-78-C-0694	Naval Submarine Base, Kings Bay, Georgia
17. N62467-80-C-0277	Naval Submarine Base, Kings Bay, Georgia
18. N62467-82-C-0053	Naval Air Station, Memphis, Tennessee
19. N62467-82-C-0010	Naval Air Station, Whiting Field, Florida
20. N00140-83-C-1780	Naval Inactive Ship Maintenance Facility, Bremerton, Washington
21. N00140-82-C-5954	Naval Inactive Ship Maintenance Facility, Pearl Harbor, Hawaii
22. N00140-83-C-1779	Naval Inactive Ship Maintenance Facility, Philadelphia, Pennsylvania
23. N00140-82-C-6888	Naval Inactive Ship Maintenance Facility, Portsmouth, Virginia
Air Force—41 contracts	
24. F05604-82-C-0052	Concrete Missile Early Warning Station, North Dakota
25. F64605-83-C-0050	Wake Island Air Force Base
26. F23608-83-C-0002	Richards-Gebaur Air Force Base, Missouri
27. F61101-80-C-0018 ^a	Thule and Sondrestrom Air Force Bases, Greenland
28. F61101-83-C-0015 ^a	Thule and Sondrestrom Air Force Bases, Greenland
29. F05604-78-C-0328	Ballistic Missile Early Warning System, Greenland and Alaska
30. F05604-82-C-0060	Ballistic Missile Early Warning System, Greenland and Alaska
31. F05604-78-C-0327	Distant Early Warning Line, Alaska, Canada, and Greenland
32. F05604-82-C-0055	Distant Early Warning Line, Alaska, Canada, and Greenland

Appendix I
Sixty-Four Umbrella Contracts Reviewed

Contract number	Military facility/location
33 F61546-76-C-0469	Kaiserslautern, Germany
34 F65517-77-C-0001	Aircraft Control and Warning Stations, Alaska
35 F65517-82-C-0001	Aircraft Control and Warning Stations, Alaska
36 F09607-77-D-0017	Moody Air Force Base, Georgia
37 F09607-80-D-0006	Moody Air Force Base, Georgia
38 F41689-81-D-0007	Hondo, Texas
39 F61355-77-9-0013 ^a	Various sites, Turkey
40 F04690-82-C-0005	Sunnyvale Air Force Station, California
41 F04690-82-C-0003	Sunnyvale Air Force Station, California
42 F05604-78-C-0262	Cobra Dane, Alaska
43 F05604-77-C-0235	Cobra Dane, Alaska
44 F05604-81-C-0050	Cobra Dane, Alaska
45 F41689-78-C-0082 ^a	Vance Air Force Base, Oklahoma
46 F41689-83-C-0045 ^a	Vance Air Force Base, Oklahoma
47 F41689-82-C-0047	Sheppard Air Force Base, Texas
48 F08606-84-C-0001	Eastern Test Range (various sites)
49 F40600-77-C-0003 ^a	Arnold Engineering Development Center, Tennessee
50 F40600-81-C-0004 ^a	Arnold Engineering Development Center, Tennessee
51 F29601-80-C-0046	Holloman Air Force Base, New Mexico
52 F26600-81-C-0024	Nellis Air Force Base, New Mexico
53 F26600-81-C-0060	Nellis Air Force Base, New Mexico
54 F61355-81-C-0008 ^a	Various sites, Turkey
55 F61355-83-C-0007 ^a	Various sites, Turkey
56 F61817-80-C-0002	Various sites, Spain
57 F61546-83-C-0024	Various sites, Spain
58 F61546-82-C-0042	Various sites, Greece
59 F61546-79-C-0021	Various sites, Greece
60 F61546-80-C-0029	Kaiserslautern, Germany
61 F04703-81-C-0101	Western Test Range (various sites)
62 F08635-82-C-0384	Eglin Air Force Base, Florida
63 F08606-78-C-0004	Eastern Test Range (various sites)
64 F04690-81-C-0004	Sunnyvale Air Force Station, California

^aContracts of bases visited.

Reasons for Deciding Not to Exercise Umbrella Contract Options

As of August 1984, umbrella contract extensions and renewals were awarded for 99 (or 91 percent) of the 109 continuation years that could have been awarded. The remaining 10 continuation years, which were all based on contract options, were contained in five contracts. The primary reasons given by contracting officials for not exercising the options in these contracts were

- a successful protest of the underlying contract award because the winning contractor was required to be, but was not, a small business (none of the 3 unpriced option years were exercised);
- unsatisfactory contractor performance (neither of the 2 priced option years were exercised);
- debarment of the contractor (2 of the 4 unpriced option years were not exercised);
- the belief that there were too many contract changes to exercise the options and higher level advice not to exercise based, in part, on the noncompetitive nature of the unpriced contract options (2 of the 4 unpriced option years were not exercised); and
- sufficiently stabilized political conditions in a foreign country which allowed competition based on a new solicitation in place of the originally noncompetitively awarded contract (1 of the 2 priced option years was not exercised).

Two Additional Examples Demonstrating the Potential for Greater Cost to the Government If All Years of the Contracting Cycle Are Not Included in the Initial Award Evaluation

We found two additional examples that demonstrated the potential for greater cost to the government if all years of the contracting cycle are not included in the evaluation for award.¹ For these two examples (see table III.1), a different contractor may have been selected if the evaluation for award had been based on the price proposals for only the first 9-month contract period rather than on proposals for the entire contracting cycle of nearly 3 years.² During the initial period, the government could have saved \$37,903 (4.9 percent of the first period cost) for one contract and \$62,175 (9.3 percent) for the other. However, over the entire contracting cycle, the government would have had to pay \$137,794 (4.8 percent of the total cost) and \$97,977 (4 percent) more, respectively, than the offers actually selected. This demonstrates that making more effective use of competition, by evaluating the whole contracting cycle, can lead to savings and greater assurance of fair and reasonable prices.

Table III.1: Two Additional Examples: Proposed Prices for the Initial Periods Versus All Periods in the Contracting Cycles

	Proposed price for initial period in the contract cycle	Proposed price for all periods in the contract cycle
Example 1:		
Firm A	\$768,802	\$2,845,771 ^a
Firm B	730,899	2,983,565
	(Firm B is \$37,903 lower.)	(Firm B is \$137,794 higher.)
Example 2:		
Firm A	\$668,761	\$2,455,351 ^a
Firm B	606,586	2,553,328
	(Firm B is \$62,175 lower.)	(Firm B is \$97,977 higher.)

^aIn each example, Firm A was awarded a cost plus fixed-fee type contract.

¹One example is shown in chapter 4.

²Since both of these contracts were cost plus fixed-fee type contracts and the source selection evaluation criteria gave only 10 percent weight to price factors, the results of the evaluation of all nonprice factors among the responsible offerors would have to have been roughly equivalent before price would have become a significant factor in determining who actually received the contract awards.

DOD Comments

Note: GAO comments supplementing those in the report text appear at the end of this appendix



ACQUISITION AND LOGISTICS

(DASD(P) CPA)

ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301-8000

31 JAN 1986

Mr. Frank Conahan
Director
National Security and International
Affairs Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) Draft Report, "Practices Used to Award, Extend, and Renew DoD's Umbrella Base Support Contracts Need Revision," dated December 3, 1985, GAO Assignment Code 942197, OSD Case 6891.

The GAO report is both informative and constructive. The DoD, however, has several concerns with the report. Principal among these concerns is the potential for inadvertent application of the recommendations to contracts and contracting methodologies other than base support service contracts. While the GAO audit concerned the use of umbrella contracts for base support services only, it made certain of the recommendations applicable to all service contracts and others could be interpreted as applying to contracts for systems or supplies. The Department intends to examine FAR coverage pertaining to options for all types of acquisitions and will consider your conclusions during this review. An additional concern is that the definition of "priced" options provided in the draft report requires change to be complete.

Detailed responses to each of the findings and recommendations in the draft report are enclosed.

Sincerely,

James P. Wade, Jr.

Enclosure

See Comment 1.

GAO DRAFT REPORT - DATED DECEMBER 3, 1985
(GAO CODE 942197) - OSD CASE 6891

"PRACTICES USED TO AWARD, EXTEND, AND RENEW DOD'S
UMBRELLA BASE SUPPORT CONTRACTS NEED REVISION"

DOD RESPONSES TO GAO
FINDINGS AND RECOMMENDATIONS

* * * * *

FINDINGS

FINDING A: Use of Umbrella Contracting. The GAO found that the Services used 64 "umbrella" contracts, valued at \$3.5 billion, for support services on military bases during FY 1977 through FY 1983. The GAO noted that (1) under this contracting approach, a contractor supplies a wide range of services rather than just a single service, (2) by using an umbrella contract, a military base can reduce the number of contracts it needs to award and administer, and (3) a military base can concentrate the responsibility for the work on a single contractor. The GAO further found that the umbrella contracts reviewed usually were competitively solicited and contained provisions for extension or renewal through options or follow-on contracts. The GAO noted that an option gives the Government the right to extend a contract at a price agreed upon at the time the initial contract was awarded; a follow-on contract is a separate, new contract for which the price is noncompetitively negotiated with the incumbent contractor. The GAO also found that, for the 64 umbrella contracts in effect between FY 1977 and FY 1983, 61 had provisions for extension or renewal. The GAO concluded that in keeping with the increased use of umbrella contracting for base support services over the past 7 years, the number of bases using such contracts could nearly triple between FY 1984 through FY 1988, and the dollar amounts involved could be sizeable. (pp. i-ii, Executive Summary, pp. 1-4, GAO Draft Report)

DOD RESPONSE: Concur.

FINDING B: Unpriced Options Are Not Valid Options. The GAO reported that the Defense Acquisition Regulation (DAR) and the Federal Acquisition Regulation (FAR) allow options to be included in service contracts if there is an anticipated need for a similar service beyond the initial contract period. The GAO found that, although these regulations do not specifically state an option must be priced at the time the underlying contract is awarded, they contain provisions that at least implicitly so indicate. In addition, the GAO found that the Comptroller General's decisions interpreting the procurement regulations clearly indicate that options must be priced at the time the underlying contract

Now on p. 2/pp. 8 to 10.

is awarded. Based on these Comptroller General decisions, the GAO concluded that, (1) if a contract option is to be valid, its essential terms (including price) must be agreed upon at the time the underlying contract is awarded, (2) if an option price is negotiated after the underlying contract is awarded, such a negotiation constitutes a resolicitation of the contract on a sole-source or noncompetitive basis and, therefore, the requirements relating to sole-source contracts apply, and (3) regulations in effect for all the contracts reviewed require examining the reasons for the procurement being noncompetitive, justifying the sole-source award in writing, and taking steps to foster competitive conditions for subsequent procurements. The GAO defined a "priced" option as a contractor's guarantee, made at the time of the underlying contract award, to perform specified work under a contract option for

- a specific dollar amount, in the case of a firm fixed-price contract;
- an amount to be determined by applying provisions (or a formula) provided in the original contract but not including renegotiation of the price for this work, in the case of other fixed-price contracts; or
- a fee to be determined by applying a formula provided in the original contract, in the case of a cost-reimbursement type contract.

The GAO further concluded that, to eliminate misinterpretation, the regulations should be revised to require contract options to be priced at the time of the underlying contract award. (pp. 8-11, GAO Draft Report)

Now on pp. 14 to 16.

DOD RESPONSE: Partially Concur. The DoD disagrees with the GAO's definition of "priced". The definition "priced", as a minimum, should be extended to include options that are subject to: a ceiling price for specific work with downward negotiations only, an economic price adjustment provision, and changes to prevailing wage rates established by the Department of Labor. The Defense Acquisition Regulatory Council will develop the required definition for use throughout the DoD during calendar year 1986.

FINDING C: Many Contracts Contain Unpriced Options. The GAO reported that as of August 1984, 54 (2 were excluded) of the umbrella contracts contained option provisions for a total of 143.67 years. The GAO found that 39 contracts (72 percent) had all priced options, and 15 had either all unpriced options or a mixture of priced and unpriced options. GAO also found that these 15 contracts contained provisions for 36.5 unpriced option years--25 percent of the total number of option years--and the estimated value of these unpriced option years could total \$808 million. The GAO further found that the reasons most frequently offered by contracting officials for not pricing their options at the time of the underlying contract award were (1) the contract's statement of work could not be sufficiently defined, or (2) the options were planned too far in the future. In addition, contracting officials believed that procurement regulations permitted the use of unpriced options.

The GAO noted that exercising an unpriced option after award of the underlying contract is, in effect, a noncompetitive (or sole-source) contract award and the regulations require such awards to be justified in writing. The GAO found, however, that the required written justification supporting a sole source award was not prepared for 19 of the 21 unpriced options reviewed. Even though written justifications were not prepared in most instances, the GAO recognized that the circumstances surrounding a noncompetitive award may have justified it. However, the GAO concluded that if the contract options could not be priced at the time of the underlying award, the option provisions should have been excluded from the solicitations and the contracts. The GAO further concluded that the requirement to price all contract options at the time of the underlying contract award is not clearly understood, as evidenced by (1) the existence of unpriced option provisions in umbrella base support service contracts, (2) the failure to justify the exercise of these unpriced options as noncompetitive awards, and (3) comments from contracting officials. The GAO also concluded that as a result, the important benefits competition is intended to achieve were foregone without appropriate justification. (pp. 12-19, GAO Draft Report)

DOD RESPONSE: Partially Concur. The DoD generally agrees with the finding as written. However, some change could occur if a more complete definition of "priced" were applied. (See response on Finding B.)

FINDING D: Noncompetitive Follow-On Contracts Should Be Avoided. The GAO found that, for five umbrella contracts, officials within the Air Force awarded preplanned, noncompetitive follow-on contracts as a means of (1) renewing contracts initially awarded competitively and (2) continuing the relationship with the incumbent contractors. The GAO reported that the five contracts involved a total of 18 planned years of noncompetitive follow-on contracts with a value conservatively estimated at \$246 million, and as of August 1984, 11 had been awarded after noncompetitive negotiations with the incumbent contractor. The GAO further found that these follow-on contracts were awarded based on a policy of extended contractual coverage developed within the Air Force, which permits elimination of competitive solicitation for up to four additional 1-year periods after the initial competitive award, and does not require the contracting officer to prepare a noncompetitive justification, as required by procurement regulations, for any of the future four 1-year periods. The GAO pointed out that the Federal Procurement Data System classifies such contract actions as noncompetitive. The GAO concluded that each follow-on contract negotiated with the incumbent, after the initial competitive contract has been awarded, is a noncompetitive sole-source award and labeling a contract as "follow-on after competition" does not make it competitive. The GAO further concluded that instead of using this policy to convert such follow-on contracts to competitive ones, priced options or other authorized procurement techniques should be considered that include all planned continuation years in the contracting cycle. The GAO also concluded that if a noncompetitive follow-on contract is awarded because these other techniques are determined inappropriate, then

Now on pp. 16 to 21.

Now on pp. 3 and 4/
pp. 26 to 29.

a written justification for using other than competitive procedures must be prepared. (p. iv, Executive Summary, pp. 20-25, GAO Draft Report)

DOD RESPONSE: Concur in general. The DoD agrees with the content of the finding as applied only to base support service contracts.

FINDING E: Excluding Continuation Periods From The Initial Award Evaluation Makes Competition Less Effective. The GAO noted that the Services normally have a continuing need for the support services provided under umbrella contracts; therefore, the Services generally use contracting practices that enable them to retain contractors for longer than one year. Although the Services have generally extended or renewed incumbent contractors' initial contracts, the GAO found 21 initial awards of umbrella support service contracts for which some or all of the out-years of the planned contracting cycle were excluded from the evaluation for the initial award. The GAO conservatively estimated the value of these unevaluated continuation periods to be \$1 billion. The GAO further found that by not evaluating all of the options in awarding umbrella contracts, even though a substantial likelihood exists that the unevaluated options will be exercised, means (1) only contractor proposals relating to the initial evaluated period can affect the outcome of the competitive process and (2) the competitive pressures and incentives are not brought to bear to keep the option prices down. Several examples were cited to demonstrate that evaluating the whole contracting cycle can make competition more effective, leading to possible savings and greater assurance of fair and reasonable prices. The GAO concluded that because part of the planned contracting cycle was excluded from consideration in 21 umbrella contracts, the effectiveness of competition was limited and the Government had reduced assurance of fair and reasonable prices in these contracts. (pp. 26-34, GAO Draft Report)

Now on pp. 32 to 38.

DOD RESPONSE: Partially Concur. See response to Recommendation 4. This finding should be applied only to base support service contracts and should permit contracting officers to justify not evaluating options for base support services on the ground that such evaluation cannot be adequately structured to avoid contractor gaming. Further, as is indicated in the report, contracting officers are required by FAR 17.207(d) to determine that exercise of any option is in the best interest of the government through a marketplace comparison or by the issuance of a solicitation. This requirement adequately protects the Government's interests.

FINDING F: Regulatory Requirements Need To Be Revised. The GAO found that an important reason why continuation periods were unevaluated was that many of them were not priced at the time of the initial contract award. The GAO also found that, although most of the priced options on the umbrella contracts were included in the evaluations for the initial awards, the regulations do not require such options to be evaluated. GAO concluded, therefore, that the use of priced options will not necessarily result in the options being evaluated whenever appropriate in awarding umbrella contracts for base support services. The GAO also concluded that, because of

the strong likelihood of exercising options to extend umbrella support service contracts, pricing and including these options in the evaluations for the initial contract awards would generally improve the effectiveness of competition and could result in saving the Government money. The GAO noted that the FAR presently does not specifically address the evaluation of options to extend service contracts, although it does outline steps that must be followed if options for additional quantities are to be considered in the award evaluation. In addition, GAO found that FAR also limits its discussion of including option quantities in the award evaluation to certain types of contracts and does not include reimbursement type contracts. The GAO concluded that although FAR presently allows options to be included in the evaluation for award, this practice is not emphasized strongly enough for service contract options which are likely to be exercised. The GAO further concluded that this lack of emphasis may be a primary factor contributing to the exclusion of options from the evaluation for initial award of base support service contracts. The GAO finally concluded that FAR should also address including options in cost reimbursement as well as fixed price service contracts. (pp. 34-37, GAO Draft Report)

Now on pp. 39 and 40.

DOD RESPONSE: Partially Concur. The DoD agrees to initiate action to revise the FAR to address the matter of including options in cost reimbursement as well as fixed price base support service contracts. (See prior response on Finding E.)

RECOMMENDATIONS

RECOMMENDATION 1: The GAO recommended that the Secretary of Defense take action to have the FAR amended to clearly require all contract options to be priced at the time the initial underlying contract is awarded. (p. 9, GAO Draft Report)

Now on p. 21.

DOD POSITION: Partially Concur. The DoD agrees that the FAR should be changed to require base support service contract options to be "priced". The DoD does not agree, however, that the GAO definition of "priced" is adequate. At a minimum, the definition should be revised to include options that are subject to: economic price adjustment provisions, changes to prevailing wage rates established by the Department of Labor or a ceiling price with downward negotiation only. The DoD will provide a definition of "priced" for DoD wide use and inclusion in the FAR.

RECOMMENDATION 2: The GAO recommended that the Secretary of Defense take the action needed to ensure, for contracts currently containing unpriced and unexercised options, written noncompetitive justifications have been properly supported and approved before the unpriced options are exercised. (p. 19, GAO Draft Report)

Now on pp. 21 and 22.

DOD POSITION: Concur. We agree to issue a general policy statement to the Military Departments and Defense Agencies to this effect. We also agree to process a FAR change through the Defense Acquisition Regulatory Council.

RECOMMENDATION 3: The GAO recommended that the Secretary of the Air Force not permit the use of preplanned, noncompetitive, follow-on contracts based on the extended contractual coverage provisions. Instead, the Secretary of the Air Force should require all planned continuation periods (follow-on years) for base support service contracts to be included in the initial contracts by means of multiyear contracts and/or priced options. If the scope of work for these continuation periods is so uncertain as to preclude reasonable pricing at the time of initial contract awards, such periods should not be included in the contracting cycle; instead, procurements for such periods should be based upon competitive resolicitation, unless a sole-source award is justified and approved in accordance with legal requirements. (p. 25, GAO Draft Report)

DOD POSITION: Partially concur. This recommendation should be clearly worded to indicate that it does not extend beyond base support service contracts. Further, what the GAO has recommended is basic policy for base support service contracts. It will be remphasized by letter to the Military Departments and Defense Agencies.

RECOMMENDATION 4: The GAO recommended that the Secretary of Defense take action to have FAR 17.206 or the related provisions of the DoD FAR Supplement amended. The amended provision should require that all options which are likely to be exercised to extend service contracts, regardless of contract type, be evaluated as part of the initial award, unless the contracting officer justifies in writing and receives higher level approval that not evaluating the options is more advantageous to the Government. (p. 37, GAO Draft Report)

DOD POSITION: Partially concur. The DoD agrees that all options likely to be exercised to extend base support service contracts, regardless of contract type, should be evaluated as part of the initial award, unless the contracting officer justifies in writing and receives higher level approval for not evaluating the options. The GAO findings leading to this recommendation, however, pertain to base support service contracts, not all service contracts. The DoD, therefore, does not agree that this GAO recommendation automatically applies to all service contracts. The DoD will review the matter and take action to revise the FAR consistent with the DoD and GAO findings.

Now on p. 29.

Now pp. 40 and 41.

GAO Comment

1. The subject report's title has been revised.

Office of Federal Procurement Policy Comments

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

OFFICE OF FEDERAL
PROCUREMENT
POLICY

JAN. 2 1986

Mr. Frank C. Conahan
Director, National Security and
International Affairs Division
U.S. General Accounting Office
Washington, DC 20548

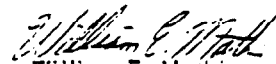
Dear Mr. Conahan:

Thank you for sending me copies of your draft report entitled, "Practices Used to Award, Extend, and Renew DOD's Umbrella Base Support Contracts Need Revision."

Members of my staff have reviewed the report, and, generally, we agree with the thrust of your recommendations. Our one suggestion is that you consider directing the recommendation on page 25 to the Secretary of Defense instead of the Secretary of the Air Force. This would conform to the recommendations on pages 19 and 37 to amend and clarify the FAR. All of the recommendations appear appropriate for inclusion in the FAR. To help accomplish this, we are considering the development of an OFPP policy letter to address the areas covered by the respective recommendations.

Your cooperation in requesting our review of the draft report is appreciated. It appears to be a good report with sound conclusions.

Sincerely,


William E. Mathis
Acting Administrator

See Comment 1.

Now on p. 29.

Now on pp. 21 and 40.

GAO Comment

1. The subject report's title has been revised.

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