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Report to the Chairman, Committee on Governmental Affairs
United States Senate

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CONTRACT PRICING

Obligations Exceed Definitized Prices on Unpriced Contracts

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National Security and
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May 2, 1986

The Honorable William V. Roth, Jr.
Chairman, Committee on Governmental Affairs
United States Senate

Dear Mr. Chairman:

On September 12, 1985, you asked us to review the Department of Defense's (DOD's) use of unpriced contracts. Accordingly, we initiated work at five contractor locations[1] with the primary objective of determining if contracting officers were properly using unpriced contracts and pricing them on time. As part of this review, we have examined 716 unpriced contracts that were definitized in fiscal year 1985 and found that DOD obligated an average of 12 to 37 percent more than was needed at the 5 locations. Total obligations for these 716 contracts exceeded definitized prices by $136 million, or 18 percent. Most of the contracts remained unpriced for over a year. We believe this is a particularly serious problem in view of the magnitude of unpriced DOD contracts—$27 billion at the end of fiscal year 1985. While the results of our work cannot be projected to the $27 billion universe of unpriced actions, the problem of excess obligations could be widespread. Although we will include this information in our final report to you, we believe the matter needs to be brought to the attention of the Secretary of Defense now so corrective action can be taken.

Obligating excess funds has several adverse effects. First, and foremost, it ties up funds for extended periods of time that could be used to meet other requirements. It also distorts the amount of funds DOD has available for obligation. In effect, DOD has more funds available for other requirements than its financial management systems indicate.

Because much of a contractor's profit is related to contract cost, by not definitizing prices on time and obligating more than the work is estimated to cost, a contractor's incentive to control costs is reduced. Also, obligating more than is necessary to pay final prices reduces a contractor's incentive to submit proposals and negotiate contracts promptly.

[1]The contractor locations are. General Electric Corp., Aircraft Engine Business Group, Evendale, Ohio; McDonnell Douglas Corp., St Louis, Missouri; FMC Corporation, Ordnance Division Operations, San Jose, California, Texas Instruments, Defense Systems and Electronic Group, Dallas, Texas; and Westinghouse Electric Corporation, Defense Group, Defense and Electronic Systems Center, Baltimore, Maryland.

The DOD Annual Statement of Assurance for fiscal year 1985[2] identified the pricing of unpriced contracts as a DOD-wide material internal control weakness. The military services have initiated numerous actions to strengthen controls over the use of unpriced contracts. However, these actions do not completely address the problem of excess obligations. We recommend the Secretary of Defense take steps to (1) review existing unpriced contracts to deobligate excess funds and (2) strengthen internal controls to prevent excess obligations in the future.

What Are Unpriced Contracts?

Unpriced contracts authorize contractors to start work and incur costs before final agreement on terms and conditions, including price. Because they are awarded without firm or final prices, such contracts are not a desirable form of contracting. Unpriced contracts do not provide the necessary incentives to achieve cost controls since the contractor bears minimum cost risk and operates in a cost-plus mode until negotiations are complete. Properly used, unpriced contracts can be a useful tool to support urgent operational needs. Four commonly used types of unpriced contracts are described below.

- Letter contracts. A letter contract is a written preliminary contractual instrument that authorizes the contractor to begin manufacturing supplies or performing services immediately.
- Provisioned items orders. An unpriced order issued under a contract which sets forth the government's requirements for initial spare parts and equipment to support new weapon systems.
- Basic ordering agreements. A basic ordering agreement is used to expedite acquisitions when specific items, quantities, and prices are not known at the time the agreements are executed, but past experience or future plans indicate a substantial need for the items or services. Basic ordering agreements become binding contracts when accepted by both parties. Orders can be issued either priced or unpriced.
- Contract modifications. These are changes or additions to existing contracts that are issued with estimated or ceiling prices. For example, an existing spare parts contract could be modified by adding orders for additional parts.

[2]The Federal Managers' Financial Integrity Act of 1982 requires that the head of each federal agency provide an annual statement of assurance to the President and the Congress on whether the agency's internal control systems fully comply with the act's requirements. The goal of the legislation is to help reduce fraud, waste, and abuse, as well as to enhance management of federal government operations through improved internal control and accounting systems.

DOD Obligated More Than the Contracts Were Estimated to Cost

We reviewed 716 unpriced contracts at 5 contractor locations that were definitized in fiscal year 1985. Our work shows that DOD obligated an average of 12 to 37 percent more than was needed at the five locations. The amount of excess obligations at each location is summarized in table 1.

Table 1: Excess Obligations Resulting When Unpriced Contract Prices Are Definitized

Contractor	Number of contracts examined	Obligation amount	Definitized price	Excess obligations	Percentage of excess to obligation amount
McDonnell Douglas	392	$227,666,140	$164,443,741	$ 63,222,399	27 8
Westinghouse Electric	65	406,172,903	358,394,705	47,778,198	11 8
Texas Instruments	81	76,545,907	67,007,494	9,538,413	12 5
General Electric	145	30,435,668	23,552,121	6,883,547	22 6
FMC	33	22,097,610	13,867,483	8,230,127	37 2
Total	**716**	**$762,918,228**	**$627,265,544**	**$135,652,684**	17 8

The Naval Audit Service has also identified excess obligations on unpriced contracts. According to a December 1985 report (S20205), the Audit Service found $40.4 million of excess obligations on 100 unpriced contracts at 4 contractor locations (1 of which was in our review). The average amount of excess obligations at these four locations ranged from 15 to 27 percent. The Audit Service projected the total excess obligations at the four locations to be $699 million.

When DOD enters into an unpriced contract, a "not to exceed" or "ceiling" price is established. This price limits the government's liability and is usually based on either the contractor's estimated cost for the work to be done or the contractor's estimate plus a percentage.

We found that DOD was funding unpriced contracts at ceiling prices. We believe this practice is the primary cause of the excess obligation problem. At McDonnell Aircraft Company, for example, all unpriced contracts for F/A-18A aircraft spares were funded at the ceiling price. The contractor and administrative contracting officer established a constant ceiling price factor for such contracts that was 140 percent of the contractor's estimate to do the work. At the direction of the F/A-18A procurement contracting officer, the 140-percent factor was canceled in January 1986. Unpriced contracts are now funded to the contractor's estimate to perform the work. Our work at the other four locations, however, showed that significant excess obligations also resulted when ceiling prices were based on contractors' estimates.

Contracts Remain Unpriced for Long Periods of Time

Because unpriced contracts provide contractors little incentive to control costs, such contracts should be priced at the earliest possible date. Procurement regulations generally provide that unpriced contracts should be definitized within 180 days. As shown in table 2, many contracts remained undefinitized for periods much greater than 180 days.

Table 2: Length of Time Contracts Remained Undefinitized

Contractor	Number of contracts reviewed	Number of days from award to definitization			Average number of days contracts remained undefinitized
		<180	181-360	>360	
McDonnell Douglas	392	20	91	281	493
Westinghouse Electric	65	13	14	38	411
Texas Instruments	81	8	42	31	377
General Electric	145	14	48	83	330
FMC	33	6	8	19	385
Total	**716**	**61**	**203**	**452**	

Corrective Actions Needed

Procurement regulations are practically silent regarding the amount of funds to be obligated for unpriced contracts. Recently, to establish more control over the use of unpriced contracts, the Air Force set a 50-percent limitation on the amount of funds that could be obligated for unpriced contract modifications, orders under basic ordering agreements, and letter contracts.

In October 1985 the Air Force Vice Chief of Staff issued a policy on the use of unpriced contracts which states:

"Obligation of Government funds before definitization shall not exceed 50 percent of the estimated amount of required funds unless approved in advance by the Head of the Contracting Activity . "[3]

[3]During another audit effort, we found that the Air Force Logistics Command, on December 24, 1985, delegated authority to its Air Logistics Centers to obligate more than 50 percent of the estimated value of unpriced contracts. The authority was intended to maximize the obligation of fiscal year 1984 and 1985 funds and was effective through December 31, 1985. During that time, 68 unpriced contracts were awarded with obligations totaling $391.4 million.

The Navy has not placed limitations on the amount of funds to be obligated for unpriced contracts. On the other hand, the Navy has initiated action to deobligate excess obligations on existing unpriced contracts. The Naval Air Systems Command, in October 1985, established a pricing policy on unpriced contracts which, in part, dealt with excess obligations. The policy stated:

". . excess funds should be deobligated as soon as possible so that funds can be reprogrammed for other needs."

In November 1985, the Assistant Secretary of the Navy (Shipbuilding and Logistics) also issued a memorandum directing a review of existing unpriced contracts to deobligate excess funds.

We believe the Navy and Air Force actions should improve control over the use of unpriced contracts. Neither service's actions, however, address the excess obligations problem completely. A limit on obligations for all unpriced actions on a DOD-wide basis should prevent excess obligations in the future and provide contractors an incentive to submit proposals and negotiate contracts on time. Furthermore, existing unpriced contracts should be reviewed on a DOD-wide basis to identify and eliminate excess obligations.

Therefore, we recommend the Secretary of Defense (1) review existing unpriced contracts to deobligate excess funds and (2) implement controls on a DOD-wide basis to prevent excess obligations on future unpriced contracts.

As we agreed with your Office, unless you publicly announce the contents of this report earlier, we plan no further distribution of it until 5 days from the date of the report. At that time, we will send copies to the Secretary of Defense and the Chairmen, House Committee on Government Operations and the Senate and House Committees on Armed Services and Appropriations. Copies will also be made available to others upon request.

Sincerely yours,

Frank C. Conahan

Frank C. Conahan
Director

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