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United States General Accounting Office

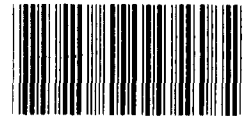
GAO

Report to the Honorable
Mervyn M. Dymally, House of
Representatives

December 1987

ARMY PROCUREMENT

Allegations Regarding Contract Awards for Water Purification Equipment



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**National Security and
International Affairs Division**

B-226511

December 28, 1987

The Honorable Mervyn M. Dymally
House of Representatives

Dear Mr. Dymally:

This report responds to your request that we review the Army's procedures in awarding and administering contracts for the procurement of the 600 gallon per hour (GPH) reverse osmosis water purification unit (ROWPU). We previously reported to you on the Army's procurement of the 3,000 GPH ROWPU.¹ The ROWPU, which is used to convert contaminated water to potable water, is essential in areas where adequate sources of fresh water are not available to meet the needs of U.S. armed forces. The ROWPU system, including the ROWPU, trailers, tanks, and other equipment, is included on the Army's Critical Items List.²

Your request stemmed from the concerns and allegations of a ROWPU contractor who maintained that the failure of the Army, the Small Business Administration (SBA), and the Department of Commerce's Economic Development Administration (EDA) to comply with existing laws, regulations, and policies had severely damaged his company's financial status and ability to continue as a viable business. The contractor stated that many of the Army's actions were intended to deny his company further participation in the ROWPU program and to injure it financially. Appendix III discusses our evaluation of the concerns raised. Your office requested that we also include general information on the Department of Defense's policy on industrial preparedness. (See app. IV for a discussion of this policy.)

Appendix I to this report discusses our objectives, scope, and methodology. Appendix II discusses the history of the Army's 600 GPH ROWPU program.

We found that the Army had administered the ROWPU contracts with the contractor in accordance with existing regulations and had complied with the Federal Acquisition Regulation (FAR) in seeking competitive

¹ Army Procurement: Restricted Competition for Water Purification Equipment Not Justified, GAO/NSIAD-87-129, April 28, 1987.

²The Critical Items List is a priority listing of materiel considered to be necessary for sustained combat operations.

bids for the 1985 contract. Following competitive procedures in contracting for the fiscal year 1985 ROWPU requirement, the Army selected a new contractor and saved about \$15.4 million, compared to the most recent noncompetitive price. Further, we believe the SBA acted with allowable discretion in graduating the contractor from its 8(a) program³ after 14 years of participation. We cannot comment on EDA's actions at this time due to ongoing litigation. We also found that the Army had acted with allowable discretion in determining that the mobilization base or war reserve needs for the 600 GPH ROWPU would not be compromised by awarding the 1985 contract to a new contractor and by allowing the old contractor's production line to close.

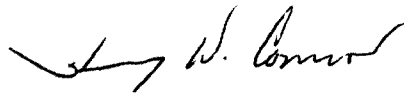
We did not find evidence that Army or other government officials had deliberately tried to cause the contractor injury. Although there were instances in which government officials could have acted with greater speed in resolving differences with the contractor and in processing certain contract changes, we do not believe that these instances were unusual or intentional. Further, we believe that many of the concerns raised by the contractor resulted from misunderstandings and differences of opinion regarding how various matters should be handled and how quickly resolution should occur.

As agreed with your office, we met with responsible officials from the Army and the Office of the Assistant Secretary of Defense and obtained their comments. These officials agreed with our observations. We did not obtain official agency comments.

³Section 8(a) of the Small Business Act, as amended, gives SBA the authority to enter into procurement contracts with federal agencies for the purpose of subcontracting with socially and economically disadvantaged small businesses. This authority is intended to help these small businesses achieve competitive positions in the marketplace.

We are sending a copy of this report to Senator Jesse Helms. Unless you publicly announce its contents earlier, no further distribution of this report will be made until 30 days from its date. At that time, we will make copies available to the Secretary of Defense, the Secretary of the Army, and other interested parties.

Sincerely yours,



Henry W. Connor
Senior Associate Director

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Abbreviations

CIL	Critical Items List
DCASMA-LA	Defense Contract Administration Services Management Agency-Los Angeles
DCASR-LA	Defense Contract Administration Services Region-Los Angeles
DOD	Department of Defense
EDA	Economic Development Administration
FAR	Federal Acquisition Regulation
GAO	General Accounting Office
GPH	gallon per hour
IPPL	Industrial Preparedness Planning List
IPPP	Industrial Preparedness Planning Program
ROWPU	reverse osmosis water purification unit
SBA	Small Business Administration

Objectives, Scope, and Methodology

Our objectives were to evaluate the Army's administration of contracts for procurement of the 600 gallon per hour (GPH) reverse osmosis water purification unit (ROWPU) and to determine whether actions the Army took were in accordance with federal procurement regulations. Also, we considered allegations that actions were taken by government personnel with the express purpose of financially injuring a ROWPU contractor.

We reviewed pertinent documentation from the contract files and interviewed responsible government officials at Fort Belvoir Research and Development Center, Fort Belvoir, Virginia; Troop Support Command, St. Louis, Missouri; Defense Contract Administration Services Management Agency, Los Angeles, California; and U.S. Marine Corps Headquarters, Arlington, Virginia. We also interviewed personnel from the offices of (1) the Army Deputy Chief of Staff (Logistics) at the Pentagon and (2) the Deputy for Procurement, Deputy Assistant Secretary of the Army (Acquisition), at the Pentagon. We contacted Small Business Administration (SBA) officials concerning the 8(a) program and reviewed SBA's regulations for administering the program. In addition, we interviewed the contractor and reviewed documentation provided relating to his allegations.

We selected items from the Army's Critical Items List (CIL) to determine the Army's practice concerning planned producers. Since we did not select the items statistically, we can draw no conclusions regarding the entire list. (See app. IV for detailed discussion.)

We reviewed the regulations and guidelines pertaining to the Industrial Preparedness Planning Program and discussed the program with responsible officials in the Offices of the Army Deputy Chief of Staff (Logistics) and Deputy Chief of Staff (Research, Development and Acquisition).

Our work was performed from February 1986 through April 1987 in accordance with generally accepted government auditing standards.

History of the 600 GPH ROWPU Program

Under section 8(a) of the Small Business Act, as amended, federal agencies may award prime contracts to the SBA, using noncompetitive procurement procedures, with the intent that SBA will subcontract work to a socially and economically disadvantaged small business. Under this program, the Army, on January 31, 1980, awarded a contract (DAAK70-80-C-0026) to SBA for 30 600 GPH ROWPUS. SBA, on February 22, 1980, awarded a subcontract to manufacture these ROWPUS to a participant who had been in the 8(a) program since 1970.

The total noncompetitive contract price was negotiated at \$4,724,935, with the Army agreeing to pay \$3,825,000 and SBA paying \$899,935 as a business development expense. The business development expense represented the difference between the price the Army believed was fair and the price that could be negotiated. In addition, SBA granted the contractor \$322,961 for capital facilities and equipment needed to perform the work.

This initial contract contained an option for 11 additional units. This option was exercised by the Army on September 30, 1980, at a cost of \$951,462. Over the next 24 months, additional requirements for ROWPUS were generated, and through supplementals and options, the contract was increased to 441 units and a total price of about \$51.2 million. The contractor completed the contract in February 1984.

The Army received a congressional inquiry in December 1982, regarding the fact that the contract's price had increased from about \$5 million to about \$51 million without competition. The congressman expressed interest concerning whether future contracts for the ROWPU would be open to small business competition.

On April 28, 1983, the Army solicited competitive proposals for an additional 152 ROWPUS. This proposed procurement was advertised in the Commerce Business Daily as a 100-percent small business set-aside. The small business set-aside program, sponsored by SBA, is aimed at assisting small business and permits the use of competitive contracting procedures in lieu of sole source or noncompetitive contracting procedures. However, before the Army could respond to inquiries received from 57 firms, SBA requested the Army to again contract with it on a noncompetitive basis so that it could make the work available to the previous contractor.

Before responding to this request, the Army discovered that the U.S. Marine Corps, the service for which the Army was buying ROWPUS,

wanted to defer the procurement until some technical problems discovered in the ROWPUS could be resolved. Before the problems could be solved, however, the Under Secretary of the Army approved SBA's request, and the Assistant Secretary of the Army (Research, Development and Acquisition) directed that a letter contract¹ be awarded to the previous contractor. The contracting officer justified the use of the letter contract and expeditious award, stating that the contractor's production line was being kept open; that, by awarding the contract to the current contractor, a better price could be obtained; and that the contract award served the government's interest in assisting a socially and economically disadvantaged small business. The letter contract for 158 ROWPUS at a ceiling price of \$23 million was issued to the contractor on January 31, 1984.

The letter contract, however, was not issued in time to prevent the contractor's production line from closing down between contracts. Also, according to a Marine Corps official, there was not enough time to solve the technical problems identified earlier. As a result, four major components were deleted from the letter contract. Incorporating these components into the contract at a later date caused confusion, additional cost, and production delays.

On July 27, 1984, a fixed-price incentive contract, DAAK70-84-C-0012, was negotiated to definitize the letter contract at a target price of \$19,154,827, not including the four engineering components, for 165 ROWPUS. The incentive price arrangement provided for the government to receive 85 percent of any savings realized by good contract performance and the contractor to receive 15 percent. Further, it provided for the government, up to a ceiling price of \$19,559,000, to absorb 85 percent of any cost overrun and for the contractor to absorb 15 percent. This is a typical incentive arrangement. After several engineering and delivery schedule changes, which included the four engineering components, the contractor finished delivery of the 165 ROWPUS in April 1986 but had not delivered all data items required by the contract. The most recent target price was set at \$23,447,267, or a unit price of \$136,042. At the completion of our review, the final price had not been negotiated.

In 1985, the Army and the Marine Corps developed requirements for additional ROWPUS, and the Army decided that this procurement would be a small business set-aside. However, the Army discovered that this

¹A letter contract is a written preliminary contractual instrument that authorizes the contractor to begin immediately manufacturing supplies or performing services.

was not possible because, during the performance of the previous contract, a large business had become a planned producer (a contractor that agrees to produce an item in time of emergencies) under the Army's mobilization program (see app. IV), and in accordance with Army Regulation 700-90, part 2-12, this business had to be given a chance to compete for the requirement. Accordingly, the procurement was advertised as open to competition.

Several congressional inquiries were made concerning this 1985 procurement. Some congressmen suggested that the previous contractor, as a small business planned producer under the mobilization program, be given part or all of the requirement on a sole source or noncompetitive basis.

The Army answered these inquiries by pointing out that (1) the 600 GPH ROWPU had never been procured competitively although many firms had the capability to produce it, (2) the quantity being procured was too small to split and still be an economical quantity to procure, and (3) being a planned producer of an item only meant that a firm would be given an opportunity to compete for that item. The Army also noted that a large business had become a planned producer of the ROWPU and therefore must be given an opportunity to compete and that other Members of Congress had suggested that the procurement be opened to competition.

On July 8, 1985, the Army issued an invitation for bid for 111 units, with an option of up to 111 additional units. The invitation requested that firms furnish prices for both the basic quantity and the option quantity. Twenty-three firms submitted bids. The low responsible bidder, a small business, won the competition for the 222 units with a bid of \$14,704,846, or a unit price of about \$66,238. This unit price was about \$69,804 less than the unit price paid under the 1984 contract. The previous 8(a) contractor was the 11th lowest bidder with a bid of \$23,316,667, or a unit price of about \$105,030. A fixed-price contract was awarded to the winner on October 31, 1985.

On July 22, 1986, the Army again solicited bids, using full and open competition, for an additional 638 600 GPH ROWPUS. The low responsible bidder offered a total price of \$40,463,722, or a unit price of \$63,423. This contractor was not the firm that had won the contract awarded in 1985. The 1985 winner was the eighth lowest bidder. The 8(a) contractor was the 13th lowest bidder at a total price of \$48,987,816, or a unit

**Appendix II
History of the 600 GPH ROWPU Program**

price of \$76,783. The contract was awarded on February 10, 1987. The first delivery of production units is not due until September 5, 1988.

GAO's Evaluation of Concerns Raised

Our evaluation of the allegations raised by the 8(a) contractor concerning Army practices and procedures in procuring the initial 600 GPH ROWPUS is discussed below.

Army's Participation in the 8(a) Pilot Program

The 8(a) contractor said that the Army had expressed dissatisfaction with being chosen as the test agency for the pilot 8(a) program established by Public Law 95-507, October 24, 1978.² Further, the contractor suggested that if SBA had not obtained the ROWPU program through SBA's pilot program, the Army would not have made the ROWPU available to the regular 8(a) program. Records indicate that, although the Army had reservations about being chosen as the test agency, it was fully supportive of the 8(a) program in general and was, at the time, considering offering the ROWPU procurement to SBA for the regular 8(a) program.

In March 1980, SBA testified before the Congress that the Army was the federal agency most supportive of the 8(a) program. The Army, however, opposed its continuation as the test agency for the pilot program because it believed that greater benefits could be achieved if SBA obtained the participation of agencies that were not cooperating in furthering the regular 8(a) program. In our 1981 report to the Congress on the pilot program,³ we endorsed the Army's position on this matter. We concluded that, because the Army—a cooperative agency—had been selected as the test agency, the legislative objective to use the pilot program to help SBA secure more 8(a) procurements had not been fully tested.

Further, in that same report, we stated that the Army's contracting officer in charge of the ROWPU procurement had told us that, when this procurement was initially being planned, his office decided to place it in the regular 8(a) program. He informed us that the main reason this procurement was in the pilot program was that SBA needed to quickly select and award a contract in the pilot program.

²SBA uses section 8(a) authority of the Small Business Act, as amended, to obtain contracts from federal agencies and subcontract them on a noncompetitive basis to socially and economically disadvantaged small businesses. In the regular 8(a) program, agencies volunteer these contracts. In the pilot program, however, SBA has the exclusive authority under Public Law 95-507 to demand procurement requirements for firms. The pilot program was initially established for a 2-year period, which ended September 30, 1980, but was subsequently extended for 1 additional year.

³The 8(a) Pilot Program For Disadvantaged Small Businesses Has Not Been Effective, CED-81-22, January 23, 1981.

The 8(a) contractor suggested that the Army would not have followed through on its offer of ROWPU procurement to the regular 8(a) program once it had determined that the 600 GPH ROWPU program could involve almost \$100 million. However, the contractor stated that SBA, under the pilot program, had been able to force the Army to follow through and give the program to SBA. It was not possible to determine what might have been the outcome if the pilot program had not been in effect.

The 8(a) ROWPU contractor stated that the Army had not originally wanted his firm to participate in the ROWPU program. We found that there was reason for concern on the part of the Army and SBA as to whether the contractor could complete the ROWPU contract. In our 1981 report, we noted that it was questionable whether the award of the ROWPU contract in 1980 to the contractor would further the aims of the pilot program. This conclusion was based on the fact that the contractor had been in the regular 8(a) program for 9 years and had not made satisfactory progress. In fact, at the time the contractor was being considered for the ROWPU contract, SBA's Assistant Regional Administrator in Region IX, who was monitoring the contractor's progress, was recommending that the contractor be terminated from the 8(a) program based on nonprofitability, negative retained earnings, and diminished net worth due to questionable financial transactions.

Army's Desire to Open the Fiscal Year 1983 ROWPU Requirements to Competition

The 8(a) contractor alleged that the Army had violated normal procurement practices in attempting to remove the 600 GPH ROWPU from the 8(a) program while his firm was still producing the item and was in the 8(a) program. We have previously held that contracting agencies have broad discretionary authority in deciding to let contracts to SBA for the 8(a) program. We have also held that no firm has a right to a contract award under the 8(a) program, even when the action being challenged relates to (1) a procuring agency's decision not to set aside a procurement for a noncompetitive section 8(a) award or (2) an agency's decision to withdraw a procurement from the section 8(a) program.⁴

Contract records show that the Army wanted to solicit competitive bids for fiscal year 1983 requirements for the 600 GPH ROWPU rather than make another noncompetitive award under SBA's 8(a) program. We found no evidence, however, that the Army's actions violated normal procurement practices. The Federal Acquisition Regulation (FAR) states

⁴Aetna Ambulance Service, Inc., G&L Ambulance Service, B-190187, March 31, 1978.

that competitive procurement procedures should be used whenever possible.

The first production contract for the 600 GPH ROWPU was awarded by the Army on January 31, 1980, to SBA, which subcontracted under 8(a) authority to the contractor. In planning for a follow-on fiscal year 1983 requirement for the 600 GPH ROWPU, the Army determined that, rather than award a second noncompetitive contract to SBA for subcontracting under the 8(a) program, it would announce the procurement as a 100-percent small business set-aside. The Army decided not to contract with SBA because (1) other firms, including small businesses, were interested in bidding on the procurement, (2) the industrial base needed to be expanded, (3) a fair market price had not been established, and (4) SBA had not requested that the procurement be made available to it for the 8(a) program.

The Army, on April 28, 1983, advertised the procurement as a 100-percent small business set-aside in the Commerce Business Daily and received inquiries from 57 firms. However, before the Army had responded to these inquiries, SBA asked the Army to make the procurement available under the 8(a) program. Although the Army had initially rejected this request, on appeal from SBA, the Under Secretary of the Army, on October 18, 1983, approved SBA's request. In approving SBA's request, the Under Secretary noted that several congressmen were interested in making this procurement competitive and that the Army planned to open any future buys of the 600 GPH ROWPU to competition. He further stated that this last noncompetitive award should help the contractor graduate from the 8(a) program.

Approval of Some Contract Changes Delayed

The 8(a) contractor stated that the Army had deliberately delayed the approval of numerous modifications to the January 1984 contract in order to extend deliveries and to cause his firm financial harm. Contract records show that the Army took several months to approve some engineering change proposals that made up the major contract modifications. However, the records also show that the contractor was slow in providing cost and pricing data and other information needed to negotiate prices for the modifications. We found no evidence that the Army had deliberately delayed the approval of the modifications to harm the contractor.

The letter contract awarded on January 31, 1984, for 158 600 GPH ROWPUS eventually had 19 modifications—11 to incorporate engineering

change proposals and 8 to incorporate administrative, contract delivery schedule, and other changes and requirements. Although each of the 11 modifications contained from 1 to 21 engineering change proposals, the contract file shows that only 1, modification 13, had a significant effect on increasing the price and extending the delivery schedule. It accounted for about 98 percent of the total increase in the price of this contract and about 62 percent of the total slippage in the delivery schedule. Modification 13 included four major items that had been placed on "engineering hold" at the time the letter contract was awarded. The four items could not be procured until they had been incorporated into the contract by later modifications. The modification also included a first article test and initial production testing.

The contractor informed the Army that, to preclude any slippage in the delivery schedule, approval to procure the hold items was needed by July 6, 1984. On July 6, 1984, the Army provided the engineering change proposals for the hold items to the contractor and requested it to submit a cost proposal for incorporating them into the contract. Approval was not given at that time for the contractor to begin procurement of the items.

On September 10, 1984, the contractor submitted a cost proposal of \$5,131,307. Since this amount exceeded the expected price, the Army asked the Defense Contract Audit Agency to review the cost proposal; this practice is normal when negotiating large contract modifications on a noncompetitive basis and is in compliance with FAR. The contractor, before the audit agency had finished its audit, withdrew the cost proposal and, on February 28, 1985, resubmitted it in the amount of \$9,057,596.

Negotiations resumed on March 6, 1985, and on June 6, 1985, modification 13 became a part of the contract. The price agreed to was \$4.2 million. A breakdown of individual items and their amounts is shown in table III.1.

**Table III.1: Cost Breakdown of
Modification 13**

Item	Amount
First article test	\$9,838
Initial production test	261,218
Technical data	716,466
ECPs for hold items	2,115,735
Schedule extension	1,096,743
Total	\$4,200,000

Contract records show that both parties contributed to the time required to incorporate modification 13 into the contract. The records also show that the Army compensated the contractor \$1,096,743 for the estimated cost involved in schedule extensions.

Progress Payments Delayed

The 8(a) contractor alleged that Army personnel had improperly and without cause delayed certain progress payments. We found that the Army's decision to delay certain progress payments was, given the facts available at the time, in accordance with actions prescribed by FAR.

The July 1984 ROWPU contract allowed the contractor to receive periodic reimbursements (progress payments) of 95 percent of eligible costs incurred. This 95-percent progress rate was normal for small businesses and was in compliance with FAR.

For the first 15 progress payment requests, the Army generally made payment within 15 days of receipt. However, starting with payment request number 16 and continuing through the end of the contract to payment request number 21, the Army took an average of 36 days to make progress payments. These payment requests ranged in value from \$363,060 to \$1,391,994. None of the payment requests were denied.

On or about the time payment request number 16 was received, the Army and Defense Contract Administration Services Management Agency-Los Angeles (DCASMA-LA) became aware of certain information that indicated that the contractor might be having financial difficulties. At DCASMA-LA's request, the Defense Contract Audit Agency examined the contractor's accounts payable as of October 16, 1985, and found that over 30 percent of the accounts were more than 60 days past due. Further, the audit agency reported that the contractor's current liabilities as of December 31, 1984, exceeded its current assets by a substantial amount. Also, the report stated that, as of October 1985, the contractor

was not liquidating his accounts payable in a timely manner. When a contractor's financial condition is doubtful, FAR provides that full information on progress under the contract and on the contractor's other operations and overall financial condition should be obtained and analyzed frequently. The regulation further provides that progress payments shall not be approved before the Administrative Contracting Officer determines, in accordance with the regulation, that the contractor will be capable of completing the contract.

DCASMA-LA decided that prepayment audits of the contractor's financial records, contacts with its suppliers, and other reviews would be necessary before payment. The accomplishment of these tasks and the associated reviews and approvals delayed payment for request numbers 16 through 21.

Request for a Higher Progress Payment Rate and the Army's Use of a Show-Cause Notice

To overcome cash flow problems, the contractor requested that the Army increase progress payments from 95 percent to 100 percent of costs incurred. The contractor alleged that, rather than provide the requested relief, the Army issued a show-cause notice—a notice that the Army was considering terminating the contract for default. The contractor cited this action as evidence that the Army was attempting to “economically assassinate” his company. We found that the contracting officer had not denied the request for higher progress payments. Instead, he had requested additional financial information to support the need for higher payments. The contracting officer then issued a show-cause notice, requesting the contractor to explain why performance of the contract was behind schedule. Both actions were in accordance with FAR.

The July 1984 ROWPU contract provided for periodic reimbursement of 95 percent of eligible costs incurred. This 95-percent progress payment rate is the normal rate allowed for small businesses and is in compliance with FAR. Large businesses are allowed only a 90-percent rate. FAR permits the payment of higher percentage progress payments under certain conditions. Section 32.501-2 of FAR states that a contracting officer may provide progress payments that exceed 95 percent if a contractor fully documents the need to supplement available, private financing, including guaranteed loans. FAR further states that the excess amount should be the lowest possible amount under the circumstances.

On September 30, 1985, the contractor requested that the progress payment rate be increased from 95 to 100 percent. On November 6, 1985,

the Army's contracting officer advised the contractor that the request for the rate increase required supporting financial data in sufficient detail to accurately reflect the financial condition of the company. A number of specific items were requested, such as a cash flow forecast reflecting the impact of additional financing for the subject contract performance period, a statement of the estimated costs to complete the contract, and a disclosure of efforts to obtain financing from private sources and the results of these efforts. The contracting officer also asked for clarification of the cash flow projections attached to the contractor's September 30, 1985, request letter since the figures reflected a positive cash flow at the 95-percent progress payment rate. The contracting officer's November letter stated that the additional financial data was needed to make an informed decision on the request.

The Army's files document no further action on the contractor's request for higher payments. The contractor told us that the request was not denied; it was just not resolved. He said that providing the requested additional financial information would have required extensive, extra corporate resources that were not available.

As the contractor stated, the contracting officer had sent a show-cause notice on November 6, 1985, stating that the government was considering terminating the contract for default because of the failure to perform within the time required. The use of such notices is provided for under section 49.402-3 of FAR. The notice stated that, pending a final decision, it would be necessary to determine whether failure to perform arose from causes beyond the contractor's control and without fault or negligence on its part. On November 13, 1985, the contractor replied to the show-cause notice in writing, as requested, and on November 27, 1985, the contracting officer advised the contractor that a meeting would be arranged to discuss the matter. This meeting and other negotiations resulted in a revised contract delivery schedule, and no further efforts were made by the Army to proceed with a default termination of the contract.

Army Subject to Court Order

The ROWPU contractor alleged that the Defense Contract Administrative Services Region-Los Angeles (DCASR-LA)⁵ had violated a temporary restraining order issued by the U.S. District Court, Central District of California, by paying to the Economic Development Administration

⁵DCASR-LA is the Department of Defense (DOD) activity that was responsible for administering the Army's 600 GPH ROWPU contracts with the 8(a) contractor.

(EDA)⁶ about \$1 million due his company on government contracts. The court decided that the DCASR-LA had not violated the restraining order.

On September 29, 1982, EDA made a working capital loan of \$2 million to the contractor to procure needed inventory and to expand his market. As a condition of the loan, the contractor made a security agreement with EDA that gave EDA a general lien on the company's accounts receivable, instruments, chattel paper, general intangibles, and contract rights.

On March 5, 1986, EDA notified the contractor that the loan was delinquent (monthly payments beginning August 29, 1985, had been missed) and that EDA was accelerating the maturity of the loan. Therefore, the loan balance of \$1,780,728.65 became due immediately. EDA also notified DCASR-LA of its actions and requested that funds due the contractor be turned over to EDA. On April 18, 1986, EDA notified the contractor that it had exercised its right of administrative offset under the Debt Collection Act of 1982 and that it would collect any payments due the contractor from its DOD contracts.

DCASR-LA notified the contractor, on May 14, 1986, that it would honor EDA's request for offset. The contractor, on May 22, 1986, filed a complaint for declaratory and injunctive relief against EDA and DCASR-LA, asking for a temporary restraining order to stop EDA from exercising any right of administrative offset. On May 27, 1986, the court issued a temporary restraining order that prohibited EDA and DCASR-LA from exercising administrative offset under the Debt Collection Act against funds due the contractor on any contract for which DCASR-LA was responsible. However, it did not prohibit the government from taking other actions available to it to collect debts.

On May 29, 1986, EDA notified DCASR-LA that, because of the loan security agreement, it had claim to any accounts receivable owed the contractor. On June 2, 1986, DCASR-LA paid EDA, pursuant to the security agreement, \$984,782.30 and \$21,431.45, representing all of the contractor's accounts receivable according to DCASR-LA's records.

On June 3, 1986, the contractor argued in court that DCASR-LA and EDA had not met the requirements of the Uniform Commercial Code and that, therefore, the offset requested by EDA should be declared invalid. On June 16, 1986, the court issued a Findings of Fact and Conclusion of Law on Preliminary Injunction and stated, in part, that, while EDA had

⁶EDA is an agency of the Department of Commerce.

no right of administrative offset pursuant to the Debt Collection Act of 1982, the payments made by DCASR-LA to EDA did not violate the terms and provisions of the temporary restraining order and were proper, either in compliance with the Assignment of Claims Act or qualifying as a waiver of the protection of the act.

Contractor's Removal From the 8(a) Program

The contractor stated that it should not have been graduated from the 8(a) program in 1985 because it was not yet in a position to be competitive in the commercial marketplace. SBA's record shows, however, that the contractor had participated in the 8(a) program far longer than permitted under the 8(a) regulation and had received over \$74 million in noncompetitive government contracts during the previous 5 years of participation.

The contractor first entered the 8(a) program in November 1970. In January 1980, he received his first ROWPU contract through that program, which eventually totaled about \$51.2 million. In April 1983, SBA extended the contractor's participation in the program for 2 years for a total program participation of over 14 years. During this extension, the contractor obtained a second ROWPU contract, which eventually totaled about \$23 million. Under both contracts, totaling over \$74 million, the contractor produced 606 600 GPH ROWPUS. After granting the extension, SBA requested that the Army make the second ROWPU award available for the contractor because the additional work was needed to help the contractor not only to make the transition to fully competitive status but to pursue sales opportunities in the private sector and the foreign military market.

Prior to November 1981, there was no fixed time period for participation in the 8(a) program. However, it was never intended that a firm be a participant indefinitely. The present SBA standard operating procedures manual, which covers the 8(a) program, provides that every 8(a) program participant shall be subject to a fixed program term in compliance with Public Law 96-481 and the Code of Federal Regulations. The SBA procedures manual states, in part, that a fixed program term will establish the ultimate time period during which a concern may remain in the program and the conditions thereof, regardless of whether competitiveness is reached or program completion action is effected. The procedures manual further states that the maximum fixed term for all concerns shall be 5 years and that these terms shall apply to concerns that are applying for entry into the program and that are currently in

the program. The fixed term may be extended for 2 years, but there may be no further extensions.

We have previously held (see Aetna Ambulance Service, Inc., G&L Ambulance Service, B-190187, March 31, 1978) that no firm has a right to an 8(a) contract award. We further stated that this is so regardless of whether the action being challenged relates to an SBA determination that a firm should not be continued in the section 8(a) program.

In our April 8, 1981, report to the Congress on the 8(a) program,⁷ we criticized SBA for failing to establish fixed graduation dates or to move firms out of the 8(a) program. We noted that not doing so prevents other firms from participating in and benefiting from the program.

Buy-In on Fiscal Year 1985 Contract

The contractor alleged that the winner of the fiscal year 1985 competition for the 600 GPH ROWPU would not be able to perform because it had bid too low, or had "bought in," to the ROWPU program. He stated that, to make it possible for this contractor to perform, the Army planned to permit it to obtain certain critical components from sources other than those required by the solicitation. Contract records show, however, that the Army has not granted, and does not plan to grant, a waiver to the required component sources.

The 1985 contractor, also a small, minority-controlled business, won the competition with a bid of about \$14.7 million, covering the contract quantity plus a 100-percent option quantity. This bid was about \$8.6 million less than the former contractor's bid. The Army's project engineer told us that he had been informed by officials of the 1985 contractor that the company had made the low bid to keep one of its plants open, not to make a profit.

We have recognized in prior decisions that there are a number of legitimate reasons for a firm deemed capable of performing to submit a below-cost bid for a fixed-priced contract and that such a bid does not, in itself, provide grounds for rejection. We also recognized that it is the procuring agency's responsibility to ensure that losses resulting from below-cost bidding, or a "buy-in," are not recovered through change orders or in any other way.

⁷The SBA 8(a) Procurement Program—A Promise Unfulfilled, CED-81-55, April 8, 1981.

Industrial Preparedness Policy

The 8(a) contractor had some concerns about how the industrial preparedness policy had been applied. Basically, it is the policy of DOD and the military services to depend heavily on private industry to produce required materiel and equipment. As such, defense industrial preparedness involves the development and maintenance of a national industrial base, made up of private business firms and government-owned facilities that are capable of supporting military operations during peacetime, mobilization, and wartime. Ensuring an orderly and effective transition from a peacetime production environment to a wartime production environment is critical to industrial preparedness.

Contractor's Concerns

The 8(a) contractor stated that the Army should not have opened DOD's fiscal year 1985 requirements for the 600 GPH ROWPU to competition. In the contractor's opinion, relying on a new and inexperienced producer for a critical item while allowing his own production line to close was an unacceptable risk in terms of mobilization and readiness requirements. He also stated that the Army's decision was contrary to DOD's policy of keeping planned producers in a minimum state of readiness.

Army records indicate, however, that the Army had considered its requirements in terms of mobilization and readiness and concluded that its needs could be met using competitive procedures without incurring undue risk. Further, FAR and DOD's mobilization policy guidance do not prohibit the action taken by the Army. In our opinion, the Army acted with allowable discretion.

Industrial Preparedness Is Vital to Sustaining Wartime Military Operations

To carry out DOD's industrial preparedness policy, the services assess the industrial base's capability to support service mobilization requirements. Known as the Industrial Preparedness Planning Program (IPPP), this ongoing assessment (1) identifies critical materiel and equipment requirements and planned producers, (2) develops and analyzes production plans, and (3) initiates industrial preparedness measures to correct production-related deficiencies. The primary objective of this assessment is to ensure that key industries remain able during peacetime to respond quickly with the volume of war materiel necessary to sustain U.S. forces in conventional combat.

Data generated during the IPPP process help DOD and the services to ensure an industrial base adequate for the timely delivery of required product quantities for combat force modernization, readiness, sustainability, and mobilization. For example, IPPP-generated data help

planners program peacetime equipment buys to ensure a balanced supply of materiel and the reservation of critical production skills and manufacturing capability. IPPP data also help planners predict and alleviate equipment shortages; compare the cost, benefits, and risks of maintaining production base capabilities and war reserve materiel stocks; measure mobilization day production lead times; and identify potential industrial energy or transportation deficiencies.

Equipment Lists Key to Most Industrial Base Determinations

Two equipment lists, the Critical Items List (CIL) and the Industrial Preparedness Planning List (IPPL), are key to the Army's industrial base determinations. The CIL, which is updated annually, provides a priority listing of requirements for sustaining selected weapons systems and items of equipment for forces engaged in conventional global warfare. The CIL serves as the basis for IPPL development and is used as a general guide for resource allocation. The IPPL is a listing of critical end items and equipment components that require industrial planning in order for the industrial base to meet mobilization requirements. The 600 GPH ROWPU has been on the CIL for at least 2 years.

Both lists highlight critical items that will be consumed in combat and that require replacement. They are the two primary documents used by the Army for planning with industry and determining production requirements. Regulations that deal with both documents are considered guidance, not mandatory direction. Thus, mobilization requirements and other considerations can override guidance considerations.

A detailed analysis is needed to determine if an item on either list should be kept in minimum sustained production (a "warm" state). Regulations state that the determination to maintain items in a "warm" production state is based on the (1) criticality of the items to a particular service in wartime, (2) ability of the commercial sector to produce the items, (3) expected gaps or stops in production, and (4) expected rate of consumption during the first 6 months of a conflict.

A number of items on the CIL and IPPL are not in production. They are in a "cold," or nonproduction, state and are generally items (1) that have been stockpiled in adequate numbers, (2) for which production tooling is in storage and readily available, or (3) for which production plans are maintained and stored "on-the-shelf" because the items can be easily and quickly produced or assembled by commercial sources. In the case of the ROWPU, the Army owned the production plans and specifications

and had determined that numerous commercial sources could assemble this unit within an acceptable amount of time.

DOD Identifies and Designates Planned Emergency Producers

Private contractors who wish to become "planned producers" must officially indicate a willingness to produce CIL or IPPL items during mobilization and wartime and must be qualified to produce those items. Agreements with these planned producers are documented on a DOD Industrial Preparedness Program Production Planning Schedule (DD Form 1519).

Any contractor who wishes to participate in the industrial preparedness program fills out a DD Form 1519, which is validated by the service representative who assesses a contractor's capabilities to produce a specific item. Information on the form includes the (1) time required to produce an item not in production on mobilization day, (2) time required to reach a desired level of production if the company is producing the item on mobilization day, (3) percentage of plant facilities to be used to sustain a determined production level, (4) number of work shifts that would be required to sustain the production level, and (5) total number of items that would be produced during a 36-month period or until a level-off rate is reached.

By signing this form, a contractor agrees to produce a specified item for the government in an emergency situation and is then designated a "planned producer" of the item and is placed on the register of planned emergency producers.

A company is removed from the register of planned producers if it loses its capacity to produce the item, the item becomes obsolete, or the item is no longer considered critical. Participation in the program assures a contractor of being included on the bidding mailing list for any requirement of the specified item. Participation does not guarantee that a contractor will be awarded any work or given any advantage over any other firm capable of responding to DOD's needs. Nor is a promise made, in writing or implied, that a contractor will be maintained either as a sole-source producer or in a "warm," or minimum, state of sustained production.

Fiscal Year 1985 Competition

The 8(a) contractor, a small business planned producer for the 600 GPH ROWPU, was awarded the first production contract for the 600 GPH ROWPU in January 1980 and remained DOD's sole source for this item until a

competitive award was made in October 1985. The Army wanted to open the contract for DOD's fiscal year 1983 ROWPU requirements to competition because (1) a complete data package necessary for a competitive procurement was available, (2) numerous firms had expressed interest in competing, and (3) there was doubt about the reasonableness of the sole-source price. Under these circumstances, FAR places a heavy burden on an agency to justify the use of other-than-competitive procurement procedures. However, at the insistence of the contractor, SBA, and several congressmen, the Under Secretary of the Army agreed to make another sole-source award to the contractor to assist him in making the transition from a noncompetitive to a competitive position. At no time was mobilization or readiness an issue for continuing this sole-source arrangement.

When the Under Secretary agreed to make a final sole-source award to the contractor, he advised the concerned congressmen that all future requirements would be opened to competition. However, when the Army announced plans to seek competition for DOD's fiscal year 1985 ROWPU requirements, the contractor suggested that a competitive procurement would endanger the country's mobilization and readiness capabilities and requested that he again be contracted with on a sole-source basis.

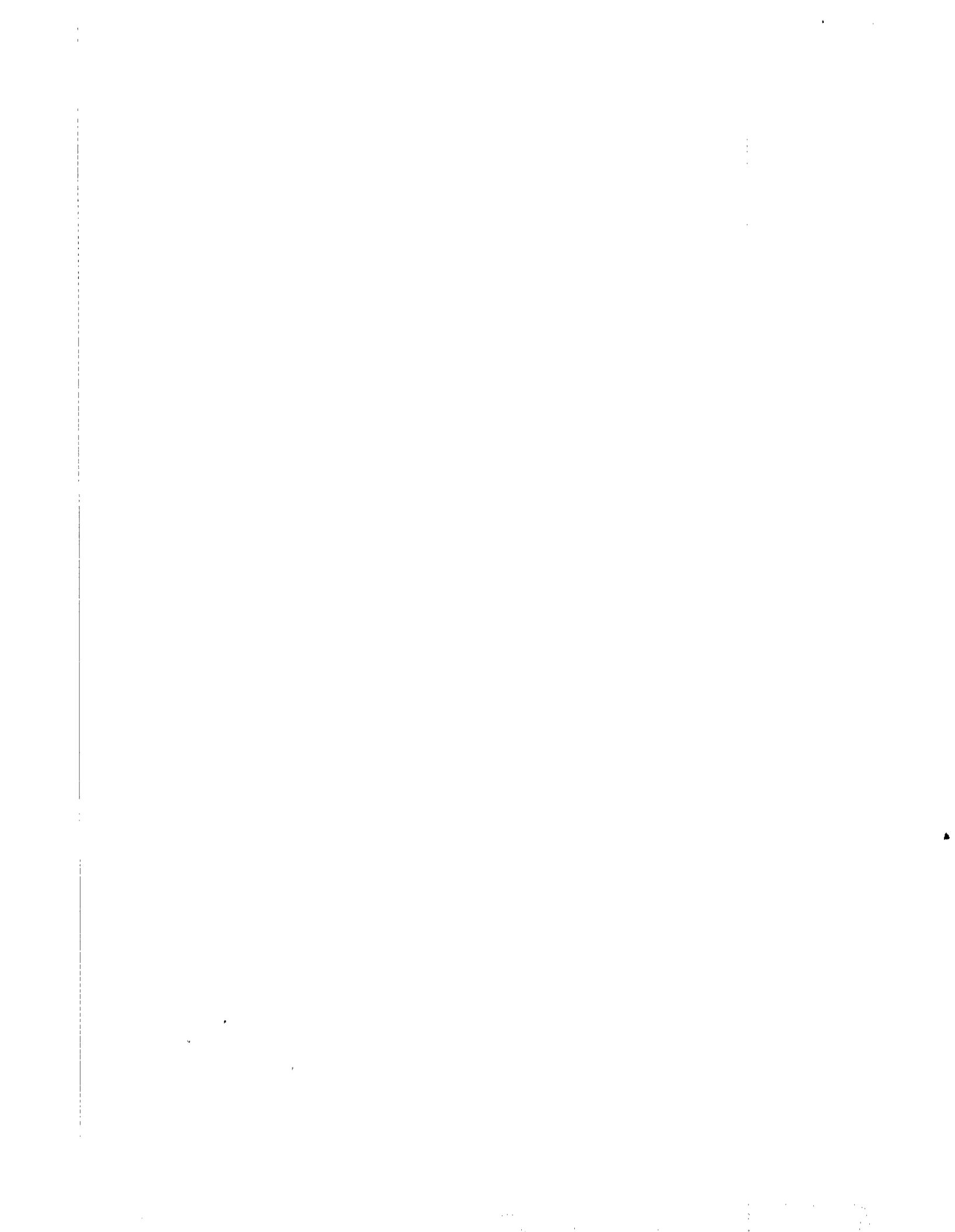
The Army acknowledged that the contractor was a planned producer for the 600 GPH ROWPU and that this equipment was included on the CIL. However, DOD's policy guarantees only that a planned producer will be given the opportunity to submit a bid or a proposal for any procurement action on the item involved. The contractor was given this opportunity in both fiscal years 1985 and 1986.

The Army, in considering the fiscal year 1985 requirements, concluded that the units on hand would meet its immediate needs and that sufficient time was available to allow competitive procedures to be used to fulfill the remainder of its requirements. Many of the Marine Corps production units were to be sent directly to storage. The Army concluded that the ROWPU did not meet the criteria for sole-source procurement for mobilization because a number of firms could produce the ROWPU in an acceptable amount of time.

The Army also concluded that competitive procedures would enhance the mobilization base by bringing in new producers. The fiscal years 1985 and 1986 contracts, awarded to different contractors, also reduced the price of the ROWPUS by almost 50 percent, thus allowing DOD to buy and field ROWPUS considerably faster with the same funding.

**Appendix IV
Industrial Preparedness Policy**

To determine whether the Army's competitive procurement of the 600 GPH ROWPU was unusual compared to the procurement of similar support equipment, we reviewed the production plans of 37 of 453 items on the Army's CIL. Of the 37 items, we found that 24 had been or were being procured competitively. The remainder were not currently in production.



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