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Contract Pricing: Dual-Source Contract Prices

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Members of the Caucus:

It is a pleasure to be here today to discuss Department of Defense (DOD) dual-source contracting. Dual-source contracting is a procurement technique in which the total government requirement is split between two contractors, with the larger share normally going to the low bidder and the smaller share to the high bidder. Thus, it is generally not a "winner-take-all" competition. In recent years, DOD has turned to dual-source contracting as a means of increasing competition in defense procurement and lowering contract prices.

At Senator Roth's request, we recently completed a review¹ of 8 dual-source contracts. Our review was directed at determining whether DOD contracting officers had sound bases for negotiating fair and reasonable contract prices. We did not attempt to determine the extent of savings resulting from dual-source contracting or whether dual-source contracting improves the industrial mobilization base, which is another of its potential benefits.

ADEQUATE PRICE COMPETITION IN
DUAL-SOURCE CONTRACTING

A major issue surrounding dual-source contracting is the degree to which competitive marketplace forces operate to ensure fair and reasonable contract prices. If competition exists, it is presumed that marketplace forces ensure fair and reasonable contract prices. On the other hand, in the absence of competition, contracting officers rely on a number of safeguards to ensure fair and reasonable prices and minimize the possibility of excessive contract prices.

¹Contract Pricing: Dual-Source Contract Prices (GAO/NSIAD-89-181, September 26, 1989)

The issue of adequate price competition in dual-source contracting was raised in a June 1988 DOD Inspector General report. The Inspector General concluded that it was unwise to assume that dual-source prices are fair and reasonable without some insight into the bases of contractors proposed prices. The Inspector General reported that DOD contracting officers incorrectly determined that adequate price competition existed on 30 dual-source contracts awarded for \$8.8 billion. I will not discuss the details of the Inspector General's findings because I know the Deputy Inspector General will do that.

In response to the Inspector General's report, the Deputy Assistant Secretary of Defense (Procurement) issued a policy memorandum in December 1988 addressing adequate price competition in dual-source contracts. The Deputy Assistant Secretary recognized the difficulty of determining whether adequate price competition existed in a dual-source contract environment and instructed contracting officers to make such determinations on a case-by-case basis after "deliberation and thorough review." The Deputy Assistant Secretary also recognized that contracting officers may need some cost data to determine whether adequate price competition exists and advised contracting officers to employ proper pricing safeguards when adequate price competition did not exist.

On May 22, 1989, the Defense Federal Acquisition Regulation (DFAR) Supplement was revised to implement the Deputy Assistant Secretary's policy and provide guidance to contracting officers. We believe the DFAR Supplement revision falls short of providing adequate guidance to contracting officers for making adequate price competition determinations. It does not stress the need for contracting officers to exercise "deliberation and thorough review" in determining whether adequate price competition exists on dual-source contracts. Rather, it presumes that adequate

price competition will normally exist on dual-source procurements and allows contracting officers to make dual-source awards without insight into the bases of the proposed prices.

CONTRACTING OFFICERS SHOULD NOT ASSUME THAT
ADEQUATE PRICE COMPETITION AUTOMATICALLY EXISTS

Determining whether adequate price competition exists on dual-source contracts is an important decision that contracting officers must make. Our work shows that contracting officers lost the opportunity to seek substantial reductions in contractors' proposed dual-source contract prices when they did not obtain insight into contractors' proposed prices. Conversely, when contracting officers obtained a thorough understanding of the bases for contractors' proposed prices, they were able to negotiate substantial reductions.

On four of the eight dual-source contracts we reviewed, contracting officers accepted the prices proposed by contractors because they believed that adequate price competition existed. Instead of obtaining insight into the proposed prices, the contracting officers relied on price analysis techniques to ensure that the proposed prices were fair and reasonable. For example, in one case, the contracting officer simply compared one contractor's proposed price to the other contractor's proposed price and awarded the contracts. When we reviewed the contractor's cost-estimating methodologies and supporting cost information we found that competitive pricing techniques were not used to develop the price accepted by the contracting officer.

In this particular instance, we found the proposed price

--did not reflect a lower updated material estimate developed by the contractor;

--was based on labor and indirect expense rates that were higher than those recommended by the cognizant government contract administration agency;

--was based on a profit rate that was higher than negotiated on a similar noncompetitive contract awarded to the contractor; and

--did not reflect material price reductions the contractor expected to achieve during vendor negotiations.

Overall, our work shows that had contracting officers obtained insight into the contractors' estimating methodologies, pricing strategies, and supporting cost information, they would have had a sound bases for seeking reductions in the prices of three contracts by as much as \$28.9 million. The three contracts were awarded for about \$390 million. The proposed price on the fourth contract was \$2.4 million below the negotiation objective that could have been established had the contracting officer obtained insight into the proposed price.

On the other four contracts, contracting officers obtained insight into contractors proposed prices, employed pricing safeguards normally used on noncompetitive procurements, and negotiated contract prices that were more than \$30 million below the amounts contractors' proposed. The four contracts were awarded for about \$330 million. The circumstances surrounding the pricing of one of these contracts provide an excellent example of the necessity and benefit of understanding the bases for contractors proposed prices. In this case, the contracting officer performed a price analysis and concluded that "the forces of competition have existed. . .and that competition has provided fair and reasonable prices for the high and low quantity awards." The contracting officer recommended award of the contracts at the proposed prices.

However, because of the significant disparity in the prices proposed by the contractors, the head of the buying activity directed further analysis to determine the reasonableness of the low quantity price. The contractor was requested to submit detailed supporting cost or pricing data. A fact-finding trip to the contractor's plant was made, a technical evaluation performed, and the Defense Contract Audit Agency reviewed the contractor's cost and pricing data. Based on the insight obtained through these efforts, the contracting officer questioned various cost elements of the contractor's proposal and achieved a \$4.6 million reduction in the price that was initially determined to be fair and reasonable because of competition.

SUMMARY

We believe the virtual assurance of contract awards to both contractors in a dual-source environment is too important a consideration to assume that adequate price competition automatically exists. The results of our review demonstrate the value of obtaining insight into contractors proposed dual-source prices as a means for determining whether adequate price competition exists and negotiating fair and reasonable contract prices.

Based on our work, we recommended that DOD revise its DFAR Supplement to provide contracting officers guidance for determining when adequate price competition exists in dual-source contracts. We believe the guidance should address the need for contracting officers to obtain a thorough understanding of contractors' proposed prices before making adequate price competition determinations. Such guidance would be consistent with the Deputy Assistant Secretary's recognition that adequate price competition determinations should be made with deliberation and thorough review.

A thorough understanding can be obtained by evaluating contractors estimating methodologies, pricing strategies, and cost information. If the insight gained through such evaluations discloses competitive pricing, the contracting officer can presume that adequate price competition exists and award the contracts. However, if the evaluation discloses noncompetitive pricing techniques, the contracting officer should rely on the safeguards normally used to negotiate fair and reasonable noncompetitive contract prices.

That concludes my statement. I would be pleased to answer any questions you may have.