

DOCUMENT RESUME

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[Review of Contentions by Hewlett-Packard Company regarding Prices Charged to the Government for the Purchase of Goods]. PSAD-78-50; B-114807. December 20, 1977. 8 pp.

Report to Rep. Paul N. McCloskey, Jr.; by Elmer B. Staats, Comptroller General.

Issue Area: Federal Procurement of Goods and Services:
Reasonableness of Prices Under Negotiated Contracts and Subcontracts (1904).

Contact: Procurement and Systems Acquisition Div.

Budget Function: Miscellaneous: Financial Management and Information Systems (1002).

Organization Concerned: General Services Administration; Federal Supply Service; Hewlett-Packard, Inc.

Congressional Relevance: Rep. Paul N. McCloskey, Jr.

Authority: Wage and Price Stabilization Act.

A review was conducted of contentions by the Hewlett-Packard Company that a GAO report failed to adequately consider differences between commercial and General Services Administration (GSA) contract terms and conditions. The report stated that some contractors charged the Government more for their products than they charged commercial customers who purchased smaller or comparable quantities. Hewlett-Packard stated that the terms and conditions under GSA Federal Supply Schedules differ from those that Hewlett-Packard gives to commercial customers, and these directly affect the price discounts offered the Government. Hewlett-Packard charged that the report failed to consider these differences.

Findings/Conclusions: The company cited GSA multiple-award contracts requiring firm-fixed prices for 12 months, while other customers must use the catalog base price effective when the order is placed, as an example of a difference in discounting. The extent that GSA benefits from requiring fixed prices for 12 months seems to relate directly to the extent that list prices increase during the 12-month contract period. Any price advantage obtained by the Government as a result of the 12-month fixed prices is minimal. The company cited the 1-year free warranty extended to the Government under multiple-award contracts, while commercial customers receive only a 90-day free warranty, as another contract difference. For most product types, the warranty given commercial customers is the same 1-year warranty given the Government. The 90-day delivery requirement generally does not create higher Government contract costs. The Government should not be expected to simply accept the contention that benefits provided by original equipment manufacturers warrant an additional discount over that given the Government. The most significant shortcoming in GSA's multiple-award schedule contracting process is nonrecognition of the anticipated aggregate amount of Government contract

purchases during negotiations. (Author/SW)

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-114807

DEC 20 1977

The Honorable Paul N. McCloskey, Jr.
House of Representatives

Dear Mr. McCloskey:

Your letter of June 6, 1977, requested that we review contentions by the Hewlett-Packard Company in its May 13, 1977, letter on our report, "Federal Supply Service Not Buying Goods At Lowest Possible Price" (PSAD-77-69, Vol. 4, 1977). Hewlett-Packard charges that our report fails to adequately consider differences between commercial and General Services Administration (GSA) contract terms and conditions. (We reported that some contractors charged the Government more for their products than they charged commercial customers who purchased smaller or comparable quantities.)

To respond to your request, we did further review work at Hewlett-Packard headquarters in Palo Alto, California; its regional offices in Santa Clara, California; and Rockville, Maryland; and GSA Federal Supply Service headquarters in Washington, D.C. We also reviewed pertinent documents, reports, and records and interviewed Hewlett-Packard and GSA officials at headquarters and regional levels.

In summary, Hewlett-Packard has provided information that should be considered by GSA when negotiating the most favorable prices for the Government. However, we emphasize that after reviewing Hewlett-Packard's data we still believe that the conclusions and recommendations reached in PSAD-77-69 should not be changed.

Our response to the four points raised by Hewlett-Packard follows.

DOES THE REPORT ERRONEOUSLY FOCUS ON DISCOUNTS RATHER THAN TOTAL COSTS?

Hewlett-Packard states that the terms and conditions under GSA Federal Supply Schedules differ from those that Hewlett-Packard gives to commercial customers, and these directly affect the price discounts offered the Government. Hewlett-Packard states that our report failed to consider these differences.

Reviewing contractors' sales, we noted the terms of aggregate purchase agreements varied between the customer and contractor. Our report stated that GSA's determination of a reasonable price should recognize aggregate annual purchases and should depend on the specific contractor and its marketing practices.

We requested that Hewlett-Packard provide additional information about cost differences that would result from the various terms and conditions.

Firm-fixed prices

Hewlett-Packard cited GSA multiple-award contracts requiring firm-fixed prices for 12 months, whereas other customers must use the catalog base price effective when the order is placed, as an example of a difference in discounting.

Hewlett-Packard equates the value of firm prices for its products sold to GSA as an additional 2.4-percent discount. Later discussions with Hewlett-Packard officials disclosed that this percentage was calculated by comparing the overall differences between GSA and commercial price changes.

Most of the Hewlett-Packard examples in our report were about the procurement of calculators. The prices of specific calculator models tend to decrease rather than increase over time due to competition, improved manufacturing techniques, and new products in the market. For example, of the six Hewlett-Packard calculator models (3 pocket and 3 desk-top) most frequently purchased by the Government from 1973 to 1975, four models decreased in commercial list price, one model increased, and one model had no price change. Similarly, GSA noted (in a review of a Hewlett-Packard contract proposal package under the calculator schedule) that from 1973 to 1974 Hewlett-Packard's commercial prices increased on only 6 of 59 product items.

The extent that GSA benefits from requiring fixed prices for 12 months (compared to other customers paying the price effective at the time of their order) seems to relate directly to the extent that list prices increased during the 12-month contract period. We found this was usually not the case for Government purchases that consist mostly of desk-top and pocket calculators. Consequently, we believe any price advantage obtained by the Government as a result of the 12-month fixed price is minimal.

Hewlett-Packard also stated that prices were controlled under the Wage and Price Stabilization Act during our review. Because of the act, Hewlett-Packard was required to apply price rollbacks not only to GSA orders but commercial customers as well. Thus, the act has affected both Government and commercial customers equally.

Warranty terms

Hewlett-Packard cites the 1-year free warranty extended to the Government under multiple-award contracts, while commercial customers receive only a 90-day free warranty, as another contract difference.

We found that for most product types (including pocket calculators) the warranty given commercial customers is the same 1-year warranty given the Government. Hewlett-Packard's corporate marketing policy manual lists nine product categories and, of these categories, with six the commercial warranty covers a full year. Furthermore, in some instances original equipment manufacturer customers receive a 15-month warranty. (An original equipment manufacturer is defined as a customer that purchases an item for integration into its own product for resale.) Therefore, Hewlett-Packard's claim that Government warranty terms are an added cost to Hewlett-Packard does not apply to most of its products.

Where the Government does indeed receive a longer warranty period than other customers, it probably is worth something and should be recognized by GSA in negotiations. However, the longer warranty's worth is dependent on many considerations, including whether the Government's extended coverage is needed and used, and to what extent commercial customers purchase additional coverage through Hewlett-Packard service contracts. If commercial customers generally do not purchase coverage beyond the 90-day free warranty, the worth of the extended Government coverage is questionable. In fact, from our discussions with a Hewlett-Packard representative, we noted that only about 25 to 30 percent of active Hewlett-Packard units are covered by service contracts.

For the Hewlett-Packard desk-top calculators reviewed in our report, we examined 21 of its maintenance agreements entered into with commercial customers during fiscal years 1974 and 1975. We found that, on the average, these customers waited 14 months after the initial 90-day free warranty period to purchase post-warranty support and service.

Similarly, our review of 15 Hewlett-Packard maintenance agreements entered into by Government customers for the same models and for the same fiscal years disclosed that these customers waited 11 months after the initial 1-year free warranty period to obtain post-warranty coverage.

A Hewlett-Packard official stated that most calculator malfunctions generally occur during the first 90 days of operation. Accordingly, we believe that for the remainder of the first year the equipment should be expected to operate trouble-free.

90-day delivery requirement

Hewlett-Packard notes that a Government agency using the Federal Supply Schedule can order a product and require delivery within 90 days regardless of quantity, provided the maximum order limitation is not exceeded. Hewlett-Packard indicates that comparable commercial agreements allow the supplier to deliver as best meets its production schedule.

The 90-day delivery requirement under GSA contracts appears reasonable for standard off-the-shelf commercial products. In reviewing 12 Hewlett-Packard weekly availability schedules for the period December 6, 1974, to July 18, 1977, we found that for the 6 Hewlett-Packard calculator models normally purchased by the Government, Hewlett-Packard was able to ship to both commercial and Government customers well within 90 days. For example, Hewlett-Packard was able to ship pocket calculators within 2 weeks and desk-top calculators within a 4- to 5-week period.

We examined Hewlett-Packard's weekly availability schedules for the period June 27, 1977, to July 18, 1977, for 11 of its other popular models occasionally purchased by the Government. We found that Hewlett-Packard could ship these products to commercial customers in 2 to 13 weeks, but usually in 4 weeks. Thus, the 90-day delivery requirement generally does not appear to create higher Government contract costs.

DOES THE REPORT INCORRECTLY ASSUME THAT CONTRACTORS WILL AUTOMATICALLY OFFER HIGHER DISCOUNTS?

Hewlett-Packard states that our report is silent about any analysis of contractors that were not awarded contracts; it supposes that no GSA bid rejections were reviewed. Hewlett-Packard notes that one test of whether GSA is getting the best possible prices is whether there are rejections

and states that potential savings in our report are pure conjecture, because there is no assurance that contractors would agree to sell to the Government at reduced prices.

We believe that the main concern is whether the discounted prices offered the Government are fair and reasonable compared with prices given to a supplier's other customers. The potential savings amounts in our report are to show how the prices given GSA compare with discounted prices given a supplier's other customers. If a supplier is unwilling to give the Government a fair and reasonable price, it should not be awarded a contract. To do otherwise would be unfair to other suppliers.

Since GSA multiple-award contracts generally involve products (such as calculators) for which there are numerous suppliers seeking Government sales, rejecting some suppliers' offers should be expected. This should not be a problem as long as the Government finds an adequate number of contractors willing to supply Government needs at fair and reasonable prices.

DOES THE CONCLUSION THAT THE GOVERNMENT IS ENTITLED TO ORIGINAL EQUIPMENT MANUFACTURER DISCOUNTS IGNORE THE FUNCTION PERFORMED BY THE ORIGINAL EQUIPMENT MANUFACTURER?

We considered the functions performed by an original equipment manufacturer and on several occasions we requested that Hewlett-Packard provide documented costs explaining the disparity between discounts available to original equipment manufacturers and those given to the Government. Hewlett-Packard did not do so, maintaining that the lower price given original equipment manufacturers was not based on any demonstrated cost savings or consideration of any particular set of cost factors. We were provided with a summary of discount policies. These policies stated that the original equipment manufacturer is typically given an additional 10-percent discount in recognition of the function performed by the original equipment manufacturer, but Hewlett-Packard made no attempt to measure the related cost savings.

We reviewed sales brochures distributed by Hewlett-Packard original equipment manufacturers. In each instance when a Hewlett-Packard calculator is incorporated into the original equipment manufacturer's product, the calculator is simply plugged into the original equipment manufacturer's product. In these instances it does not

appear that the original equipment manufacturer performs any major modifications to Hewlett-Packard items that would warrant additional discounts.

We agree that Hewlett-Packard does receive benefits from an original equipment manufacturer, primarily a definite commitment to combine its product with a Hewlett-Packard product. Hewlett-Packard also probably benefits from the manufacturer's marketing and advertising. However, Hewlett-Packard also receives benefits from GSA. For instance, GSA performs some of the marketing functions cited by Hewlett-Packard as performed by the original equipment manufacturer. When a supplier receives a GSA contract, access is automatically gained to the Federal market. To order, the Federal customer need only examine a supplier's catalog and prepare an order form--terms and conditions have already been negotiated by GSA.

The Government should not be expected to simply accept the contention that benefits provided by original equipment manufacturers warrant an additional discount over that given the Government. We believe the Government should strive for prices comparable to those given a supplier's most favored customer unless the supplier can justify any difference through measurable cost savings.

In GSA's negotiation of multiple-award schedule contracts, any responsive and responsible supplier can be awarded a contract if it offers discounts from its catalog prices that GSA determines to be reasonable. To measure reasonableness, GSA generally requires suppliers to offer discounts at least equal to the largest discount given to any other customer. This is especially important in GSA multiple-award contracts because competition among suppliers is limited and the requirement for cost or pricing data is usually waived.

IS THE GOVERNMENT A SINGLE CUSTOMER?

Hewlett-Packard maintains that the Government represents many customers, not a single customer. GSA also adopts this attitude when negotiating multiple-award contract prices. As a result, GSA virtually ignores volume discounts that suppliers give to commercial customers under annual-purchase agreements, which may also only estimate purchases rather than guarantee specific amounts.

The most significant shortcoming in GSA's multiple-award schedule contracting process is nonrecognition of the

anticipated aggregate amount of Government contract purchases during negotiations.

A critical element of any evaluation of the reasonableness of a supplier's offer is how the prices offered to the Government compare with prices given to the supplier's other, large volume customers. This evaluation should include price discounts available under annual purchase agreements to recognize cumulative purchases. If a supplier offers volume discounts to non-Government customers, the Government should pursue and receive comparable treatment.

Concerning annual purchase agreements, Hewlett-Packard notes that estimated savings based on the first part of example A in our report may be overstated since the example relates to Hewlett-Packard's entire fiscal year (Nov. 1, 1973, to Oct. 30, 1974) but that Hewlett-Packard did not offer annual agreements until July 1974.

The example was included in our report to indicate the potential savings available under annual-purchase agreements. Our review was made during calendar years 1974 and 1975 and, consequently, we concentrated on fiscal year 1974 sales data.

In essence, GSA's multiple-award contracts are annual purchase agreements under which Government agencies purchase about \$870 million in goods and services each year. A critical consideration when assessing the reasonableness of a supplier's offer is comparing the prices offered to the Government with those the supplier offers to other large-volume customers under annual agreements. In this regard we referred four cases to GSA for further investigation, in which we noted contractors failed to disclose discounts given under annual agreements. To date, the GSA Office of Audits and Investigations has audited three contractors with sales under multiple-award contracts totaling \$8 million and has recommended refunds totaling \$623,000.

A serious deficiency in GSA's negotiated-contract philosophy is GSA's attitude of negotiating for many individual Government offices individually rather than for the Government as a whole. This view negates one of the benefits associated with centralizing the Government's contracting process. Furthermore, it can effectively leave suppliers with the impression that there is no need to disclose volume discounts available under annual agreements since GSA is interested only in discounts applicable to individual agency orders.

CONCLUSION

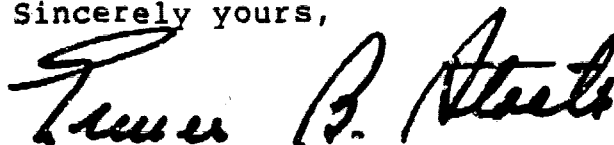
The primary objective of our original review was to determine if GSA obtained fair and reasonable prices for commercial items purchased through its multiple-award program. Our report demonstrated that GSA could be more effective in its negotiations and should have sought prices comparable to those given other customers. As a result of our additional review work, we do not believe any significant changes to our report are warranted.

We reiterate that our report stated GSA's determination of a reasonable price should recognize aggregate annual purchases and should depend on the specific contractor and its marketing practices. In this regard, the information provided by Hewlett-Packard should be considered by GSA when negotiating the most favorable prices for the Government.

As arranged with your office, we are sending copies of this report to the Hewlett-Packard Company. Copies will also be available to other interested parties upon request.

We appreciate the opportunity to respond to the objections raised by Hewlett-Packard and would be pleased to answer any further questions you may have.

Sincerely yours,



Comptroller General
of the United States